# CONSTRUCTION LAW SURVIVAL MANUAL


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## A New Bankruptcy Court Decision Provides Guidance on Drafting Trust Clauses in Construction Documents in Virginia

One of the most broadly accepted concepts in the construction business is that when a contractor receives payment on a project that contractor should use the money received to pay that contractor's subcontractors and suppliers for that same project. Certain states—including Maryland—have recognized this duty with a trust fund statute that requires that contractors hold payments received in trust for the payments of subcontractors and suppliers. Virginia does not have a trust fund statute but the Virginia Supreme Court has stated "[t]here is a moral obligation closely akin to a legal trust relation extending to both the owner and to those whose material or labor has entered into a structure, that the compensation paid therefor by the owner should not be misapplied." *Overstreet v. Commonwealth*, 67 S.E. 2d 875, 879, 193 Va. 104, 111 (1951).


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A trust fund statute can create a number of benefits. The first is the potential to modify the behavior of contractors and subcontractors in a favorable way. For example, an owner who pays a general contractor generally wants those funds to be used to pay subcontractors and suppliers. Trust duties—and the potential heightened consequences of violating those duties when compared to just breaching a contract—create a greater incentive for a contractor to use the funds for that purpose. Of course, this does not always work, but theoretically it should help.

The second benefit from a trust relationship arises after trust duties have been violated. Certain trusts may result in officers or managers of a contractor being personally liable if funds are misused. This can be a meaningful collection tool if a contracting business goes under after misusing funds.

Benefits from a trust also arise in a variety of ways when a subcontractor or contractor files for bankruptcy. The easiest example is a situation where a payment is made to a subcontractor who then files bankruptcy while still in possession of the funds. If that payment is not subject to a trust, those funds are now property of the bankruptcy estate. This means that the funds are very unlikely to find their way to that subcontractor's suppliers on that project. If the contractor who made that payment supplied a payment bond on the relevant project, the contractor might be looking at double liability. However, if the funds are subject to a trust either the contractor or the suppliers on that project may be able to claim those funds and thereby prevent a potential double liability situation. Even when the problem is just that the costs to complete the subcontractor's work will exceed the remaining balance, a trust may provide an avenue to claw back certain funds which can be used to pay the completion costs.

Despite the lack of a trust fund statute, all is not lost in Virginia. In the absence of a trust fund statute, it is generally possible to create trust obligations by contract. A recent decision from the United States Bankruptcy Court for the Eastern District of Virginia provides some guidance about a potential contract drafting pitfall that could mean that even the clear intent to create a trust via contract may not be legally enforceable.

In the case of *Gold v. Paige International, Inc. (In re The Truland Group, Inc.)*, Adv. Proc. No. 16-01015-BFK, a sub-subcontractor ("Sub-Sub") argued that payments it received were subject to two different trusts created by contract. The first arose from the contract between the relevant subcontractor ("Sub") and the relevant general contractor ("GC"). This contract stated:




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> The Subcontractor agrees and covenants that money received for the performance of this Subcontract shall be used solely for the benefit of persons and firms supplying design services, labor, materials, supplies, tools, machines, equipment, plant or services exclusively for this Project in connection with this Subcontract and having the right to assert liens or other claims against the land, improvements or funds involved in this Project or against any bond or other security posted by Contractor or Owner; that any money paid to the Subcontractor pursuant to this Subcontract shall immediately become and constitute a trust fund 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 herefrom have been fully paid.

The court determined that this clause did create a trust pursuant to Virginia law. Specifically, the court stated that the phrase "shall immediately become and constitute a trust fund" showed that the "[t]he parties clearly intended the creation of a trust." The court also determined that the Sub was "clearly restricted in the use of the property" by the clause stating that the funds "shall not in any instance be diverted." Finally, although the court noted there was no requirement that the funds be kept in a segregated bank account, the language stating that those funds "be used solely for the benefit of any subcontractors or suppliers" was sufficient to create a trust because it mandated a separate accounting for those funds.

The second trust clause at issue in that case was from an indemnity agreement between the Sub and its surety ("Surety") who had provided payment and performance bonds on the relevant project. The relevant clause in that agreement stated:

IX.

TRUST FUND

> (A) PRINCIPAL and UNDERSIGNED agree that with respect to each specific contract secured by BOND(S) executed, provided or procured by SURETY on PRINCIPAL'S behalf, all money and property representing the consideration for the performance of the contract, (including, without limitation, the proceeds of claims for adjustments, additional compensation, compensation for delay, extra work, change orders, insurance claims and all damage claims) whether in the possession of the PRINCIPAL, UNDERSIGNED or other and whether earned, unearned, paid, retained or to be paid shall be held in trust as trust funds for and shall be used solely for; (1) performance of the contract; (2) the payment of obligation(s) to subcontractor(s), laborer(s), and supplier(s) of material(s) and service(s) incurred or to be incurred in the performance of the contract for which SURETY is or may be liable under BOND(S) and; (3) the satisfaction of UNDERSIGNED'S obligations to SURETY under this AGREEMENT and all other indebtednesses and liabilities of UNDERSIGNED to SURETY.
>
> (B) PRINCIPAL shall, upon demand of Surety, deliver the consideration for the contract to a bank designated by SURETY for deposit in an account in the name of PRINCIPAL designated as a "Special Account" or "Trust Account" and withdrawals from said "Special Account" or "Trust Account" shall be by check(s) payable to the beneficiaries and for the stated purpose of this trust, signed by a representative of PRINCIPAL and by a representative of SURETY.

The court stated that the Sub-Sub's arguments based on this clause were abandoned by the Sub-Sub, but in a footnote still determined that this clause did not create a trust. The reason provided by the court was that "Article IX(B) . . . provides that 'upon demand of the Surety' all contract proceeds will be segregated and separately accounted for." While the court acknowledged as to the first trust that trust funds do not need to be segregated, it seems to have determined as to the second trust that whether or not comparable separate accounting requirements exist, the discretionary right to require segregation means that funds are not separately accounted for in the absence of a segregation demand. Therefore, a trust was not created.

The broader meaning of this ruling is somewhat harder to discern. The court states that segregation is not necessary and found that language requiring that the funds "be used solely for the benefit of any subcontractors or suppliers" was sufficient to create a trust. However, the language in the indemnity agreement similarly states that the funds be used "solely for" certain defined purposes yet the court determined the clause does not create a trust because the agreement also includes a discretionary right to also require that the funds be kept in a separate bank account. Ironically, the Surety seemingly retained a greater level of control over the funds in the possession of the Sub and this additional control was determined to mean that a trust did not exist.

In light of this decision, there seem to be a few possible drafting solutions that can increase the likelihood that a trust clause be held to create a trust under Virginia law. The easiest is to avoid including any discretionary right to require that funds be segregated. A trust clause that tracks the language in the contract between the GC and the Sub here and does not include a discretionary right to require segregation should create a trust. Essentially a trust clause should either require segregation from day one or not



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require it at all while still requiring separate accounting. This solution should work even if this decision means that the inclusion of a discretionary right to require segregation means absolutely that no trust was created.

A second and somewhat riskier drafting solution might be effective if the discretionary right to require segregation is something that cannot be removed from an agreement for some reason. This solution would be to include language that makes clear that separate accounting and the other trust obligations exist are mandatory from day one even if a demand to segregate the funds is never made. It is, however, unclear whether this would resolve the problem as the language of the clause in *In re Truland* does not seem to imply that duty to separately account for the funds required a demand for segregation to take effect. While an explicit statement that the trust arises prior to such demand is better than silence on the issue, it is unclear whether it would result in a different outcome than the one reached in *In re Truland*. This ruling might mean that a discretionary right to require segregation means that a trust cannot exist. Doing anything other than removing such a right potentially brings additional risk into play.

A third solution might be to simply use a choice of law clause to specify that the law of state other than Virginia applies to the contract containing the trust clause. At least one court has applied the law of a different state and found a trust to arise from a clause with a similar unexercised discretionary right to require segregation. The Sixth Circuit Court of Appeals decided under Kentucky law that the following clause did not prevent a trust from being formed even though a demand to segregate was never made:

> Fourth: Undersigned covenant and agree that all funds received by them, or due or to become due under any contract covered by any Bond are trust funds whether in the possession of the Undersigned or another, for the benefit of all parties to whom the Undersigned incurs obligations in the performance of the contract covered by the Bond(s) and/or the benefit of, payment to or reimbursement of the Surety for any liability, loss or expense the Surety may incur under the Bond(s) or in enforcing this Agreement. If the Surety discharges any such obligation, the Surety shall be entitled to assert the claims of any party to the trust funds. The Undersigned shall, upon demand of the Surety and in implementation of the trust, open an account or separate accounts with a bank designated by Surety, which account(s) shall be designated as a trust account(s) for the deposit of such trust funds and the Undersigned shall deposit therein all monies received pursuant to said contract. Withdrawals from such account(s) shall be by check or other instrument signed by the Undersigned and countersigned by a representative of the Surety. Notwithstanding anything to the contrary herein above this dedication may be implemented in any other manner provided at law or in equity.

*Poynter v. Great Am. Ins. Co. (In re Poynter)*, 535 Fed. Appx. 479 (6th Cir. 2013). Specifying that Kentucky law applies to the relevant contract and copying this clause might help create an enforceable clause.

There are many reasons that parties to various construction documents might want to create a trust. Such trusts are largely a manifestation of the principal—described the Virginia Supreme Court as a moral one—that funds received on a construction project should be used to pay the expenses on that project. However, careful drafting with an eye on most current case law can mean the difference between a trust that is enforceable under law or just wasted paragraphs in your contract documents.

**Questions or comments for the author?**



## MORE INFORMATION ON TRUST FUND CLAUSES FROM THE CONSTRUCTION LAW SURVIVAL MANUAL

⇒ CHAPTER 15 TRUST FUND CLAUSES AND AGREEMENTS

James D. Fullerton

# A Short Survey of Existing CUF Regulation in the DC Metro and Mid-Atlantic Region

Most public procurement projects have participation goals or requirements for minorities and other disadvantaged groups (Disadvantaged Business Enterprise or "DBE"). The DBE regulations vary for different state and federal agencies. Those DBE regulations sometimes include a "commercially useful function" (CUF) requirement of actual participation by DBEs, so that the disadvantaged groups gain actual experience in government contracting. General contractors, subcontractors and suppliers risk fines if they knowingly participate in transactions in which a DBE acts as an "extra participant in a transaction, contract or project, through which funds are passed in order to obtain the appearance of DBE participation." Read more about this issue HERE.

There are commercially useful function (CUF) requirements on only a limited number of public projects in Virginia, Maryland, Pennsylvania and the District of Columbia.

In the federal realm, there are CUF requirements only in U.S. Department of Transportation (DOT) assisted contracts, and Environmental Protection Agency (EPA)-assisted contracts.

The DOT has always had the most complete regulatory scheme for DBE participation goals. The DOT regulations are a good place to start any discussion of DBE regulation. These regulations are the most complete and have the most court and administrative case law to explain how they work. The DOT has always prosecuted what I call a more active fraud, like setting up and controlling a false DBE. General Contractors that have agreed in their contracts with the government to comply with DBE regulations are also more often regulated and prosecuted.

Suppliers and subcontractors that have not agreed to comply with DBE regulations have been investigated to a more limited extent. Those investigations have been on a CUF and False Claims Act theory, that the remote supplier knowingly participated in the submission of a false claim for payment from the government, because the supplier sold material to a "pass through" DBE that did not perform a commercially useful function on the project. It is also significant that most enforcement of CUF regulation has been on DOT projects and to a lesser extend EPA projects, with most of these in the Southern District of New York.

DOT and EPA regulation ends the federal discussion. We are not aware of any CUF regulation in the SBA Act, Department of Defense or Housing and Urban Development projects for example. Federal regulations are discussed in some length in the Construction Law Survival Manual HERE.

The DOT regulation carries over to most or all state transportation projects, either in funding agreements with the federal DOT or both Maryland and Virginia DOTs have also passed their own independent CUF regulations that largely track the federal DOT regulations. So these CUF regulations would cover any work on highways, airports or subways. In the D.C. area, that is the Metropolitan Washington Airport Authority (MWAA) and the Washington Metropolitan Area Transit Authority (WMATA).

The state of Maryland has passed at least two CUF regulations that cover most, but not quite all Maryland state and county public procurement projects. These regulations are not identical to the federal DOT regulations, but are similar and do carry the same CUF concepts. We advise clients to simply assume that any public project in Maryland has a CUF requirement. One relevant factor, however, is that we are not aware of any enforcement of CUF requirements in Maryland, other than against the general contractor (who has contractual requirements) or the DBE itself. The Maryland regulations are also discussed in some length in the Construction Law Survival Manual HERE.

There is no CUF regulation in the state of Pennsylvania, except City of Philadelphia projects. Philadelphia has unusually well-developed CUF standards and requirements. I am aware of two CUF enforcement actions in Philadelphia, discussed in the Construction Law Survival Manual HERE. However, they both involved what I call the more active fraud of setting up a false DBE and not a False Claims Act sort of enforcement.

The Virginia regulation applicable to non-transportation projects seems to speak only to whether a DBE should be certified. It is clear that the DBE can lose certification and a general contractor can be in breach of its contract with the government if any DBE is not performing a CUF. It is difficult to say what this could mean for a remote supplier that did not contract directly with a government entity and did not certify anything to any government entity. However, the federal DOT regulation seems to speak only to whether participation by a DBE should be count towards the DBE participation goals in a contract and this has resulted in penalties to remote suppliers.



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The District of Columbia Code creates a discretionary standard for the Department of Small and Local Business Development, which has the authority, but not the duty to disregard DBE participation if the DBE serves no commercially useful function in the performance of a contract. The D.C. actual performance definition of CUF is from the DOT regulations. However, the operation of the statute seems to be discretionary. Even the government agency does not have to enforce it. It is a little hard to see how it can create compliance risk for a traditional material supplier.

There is no CUF (or DBE) statute or regulation in Virginia, Maryland, Pennsylvania and the District of Columbia that applies to private projects, except that a private project must comply with the statute in D.C. if it receives "Government-assistance." "Government-assisted" is fairly broadly defined as a contract executed on behalf of the City that involves City funds or that the City administers in accordance with a federal grant; a project that receives a loan or grant from a City agency; a project that receives bonds or notes issued by a City agency; a project that receives City tax exemptions or abatements; or a development project that involves property sold or leased by the City. Many large private projects have DBE regulation as a result.

New York state regulations contain a CUF provision similar to the DOT CUF regulation. Like the federal, the state requirement means that there will be no DBE participation credit on a state contract if the DBE business utilized was not performing a CUF. Based on the federal enforcement in New York, I would be concerned about state enforcement also.

In New Jersey "only businesses performing a commercially useful function may be certified' under programs for state projects. This regulation seems to speak only to the qualification for certification as a DBE. So this is like Virginia and it is hard to say how this could impact a remote supplier.

All North and South Carolina Department Transportation projects must comply with the "commercially useful function" (CUF) requirement, but other state and private projects do not.

Questions or comments for the author?



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