



Lien Law 3A: Overview, Claims and Defenses in and out of Bankruptcy Court

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Today's Speakers

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Overview, Claims and Defenses

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**Smith Buss
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This session will . . .

Review the basics of New York State
Lien Law 3A

Define the “Trustee”, “Beneficiary”,
“Trust Asset” and “Trust Purpose”

Considers diversion and
misappropriation claims owners and
subcontractors may assert

Offers potential defenses and
proactive measures to reduce the
threat of a Lien Law 3A claim

Lien Law 3A – Purpose and Overview

Protective:

- To safeguard the rights of persons participating in construction projects by requiring owners, contractors and subcontractors to act as “fiduciary managers” regarding construction operations.

Preventive:

- To prevent responsible parties from the practice of “pyramiding” – using funds on one project to finance construction of another project or other purpose.

Wide-ranging:

- An expansive (and potentially expensive) statute to include assets “of every conceivable type” arising from a project

The “Trustee” and the “Beneficiary”

The Trustee:

- Holds or is responsible for the trust assets
- **Personal Liability Warning:**
 - “Knowingly causes misappropriation”
 - Ex: President of contractor corporation who used trust funds to pay non-project debts

A Trustee is not:

- An owner’s existing mortgagee
- One who pays for services, not improvements
- Consultants

The Beneficiary is:

- One entitled to receive trust funds, including:
 - An owner whose funds contractor is still holding
 - A contractor or subcontractor, regardless of whether it filed a mechanic’s lien or holds a judgment
 - A supplier in a contractual relationship with the holder of the funds

A Beneficiary is not:

- A creditor of the owner or contractor
- A surety of the contractor or subcontractor
- A subcontractor guaranteed payment by owner (unless a contract says otherwise)

Only Beneficiaries (or their agents/representatives) may pursue Lien Law 3A claims, and only Trustees, their principals and officers, or assignees, are liable under Lien Law 3A.

Defining the “Trust Assets”

Trust assets are monies received:

- To improve real property, or under home/public improvement contracts
- Exist even if there is no contractor, subcontractor, materialman, etc. yet retained

Source of Owner trust funds:

- Building loans;
- mortgages recorded after improvements start and within 4 months of completion;
- consideration paid for conveyance recorded after improvements start and within 4 months of completion;
- Assignment of rents made after improvements start and within 4 months of completion;
- Fire and casualty insurance proceeds for destruction except to reimburse premium payments;
- Executory contract for sale and improvement (contracts including conditions to improve)

Source of contractor/subcontractor trust funds:

- Contract or subcontract for real property, home or public improvement
- Assignment of funds due or to be due
- Fire/casualty destruction insurance proceeds (except for premium reimbursement)

What does “home improvement” mean?

- Repairing, altering, adding to residential property, including driveways, pools, siding insulation, roofing, windows, terraces, landscaping, solar energy
- Broadly defined to mean nearly everything

The Trustee's Use of Trust Assets

How long do monies remain “trust assets”?

- If Owner holds – till all trust claims paid or all assets applied
- If Contractor holds – till claims made before completion are paid/discharged, or all monies are applied

The Trustee **MUST**:

- Apply funds to pay expenses “arising out of” the improvement and “incurred in the performance” of the contract or subcontract
- Deposit funds in account under Trustee’s name. Separate accounts not required if proper books/records.
- Retain books and records that include:
 - Trust assets receivables; Trust accounts payable; Trust funds received; Trust payments made; Security or repayment of advances (if any)

The Trustee **MAY**:

- Determine the order and manner of payments to beneficiaries
 - Authority terminates upon §77 order of distribution or court order
- Assign monies to assignee (and file a Notice of Lending)
- Reimburse itself for the “costs of improvements”
- Use funds to pay fair and reasonable sums to obtain building loan financing, including legal, inspection and exam fees

The Trustee's Use of Trust Assets (con't)

Subcontractors, architects, engineers, surveyors, laborers and materialmen

Taxes on payroll to be withheld and on materials/equipment required for improvements

Taxes and unemployment insurance or other contributions for employment under the claim

When the Trustee is the Contractor (or Owner as Contractor) the Trustee may use Trust Assets to pay (§ 71(2)):

Benefits and wage supplements required under the contract

Premiums on surety bonds or insurance during improvements

Payments required under contracts for sale and improvement of the real property

Rights on Enforcing the Trust

Who may bring a claim?

- Trustee or beneficiary (or agent, representative)
- Beneficiary deemed representative of class of beneficiaries under Trust
 - CPLR Article 9 (Class Actions) preconditions are waived

What kind of relief is available?

- Compelling accounting, enforcing trust rights or authority over assets, determining asset amounts, requiring security if assets may be dissipated, distribution, discharging trustee, other relief necessary
- Deferring distributions until other trust claims resolved or become available
- Entire beneficiary class benefits, except:
 - On Order to distribute available funds – only beneficiaries then entitled to receive benefit.

Rights on Enforcing the Trust (con't)

Where can the claim be brought?

- Court or arbitration
 - In either, make sure all claims are raised [res judicata]
 - If arbitration, still need to confirm award

When can the claim be brought?

- Anytime during improvements and no other claims pending
- Within 1 year of all improvements done or final payment – whichever longer
 - Not substantial completion – final
 - Does not apply to trustee actions for final settlement and discharge
 - Does not affect contract claims (6 year statute of limitations)

The priority a Court will use on an order of distribution are trust assets:

- Taxes, unemployment insurance and employment contributions
- Trust claims for laborers' daily and weekly wages
- Trust claims for benefits and wage supplements
- Remittances to laborers for daily and weekly wages deducted from payroll

The Beneficiary's Rights to Books and Records

When?

- If more than 30 days after trust claim payable but not more than once monthly
- Beneficiary chooses exam/copies or choose to receive verified statement of trust

How?

- 10 day notice by personal service, certified or registered mail
- Identify beneficiary, description of improvement, nature of trust claim
- Within 10 days, Trustee to allow examining/copying or provides verified statement

Court intervention:

- By Trustee to vacate request if requester not entitled (i.e., not beneficiary)
- By Beneficiary to compel production/statement
- Application on 3 day notice; Court may decide on affidavits without hearing

Diversion and Misappropriation of Trust Assets

Diversion of Trust Funds Occurs When . . .

- Trustee uses funds other than how § 71(1) and (2) allow:
 - Not used for payment of costs of improvement (i.e., incurred in performance of contract)
 - Not all trust claims are paid or discharged
- Trustee's intent is irrelevant (but not on larceny charge)
- Trustee fails to keep § 75 books/records – “presumptive evidence” of diversion

But it's not that clear . .

Developer spends more on trust expenses than amount of construction loan.

Court held diversion claim refuted.

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Contractor fails to keep required accounting but produces checks, vendor and financial spreadsheets, and verifies.

Court held presumption refuted – no diversion claim.

Diversion and Misappropriation of Trust Assets (con't)

If the Trustee has misappropriated Trust Funds

- Trustee (and officer, director, agent) may have committed **larceny** if:
 - Owner as trustee received funds prior to paying trust claims
 - Contractor as trustee failed to pay within 31 days of when due, unless
 - Good faith dispute raised and payment then made within 31 days to determination
 - Trustee **intended** to misappropriate (i.e., for criminality, not civil)

However, Trustee is not misappropriating where . . .

- Trustee uses funds to repay for advances already made for trust purposes
- Trustee merely determining priority of liens and payments
- Trustee retains balance after all trust claims are paid or discharged

We looked at the
elements of Lien Law 3A.

Now let's see . . .

What claims might owners
and subcontractors make
against contractors?

and

What defenses might
contractors raise to those
claims?

(note: these will overlap)

Owner's Acts and Claims

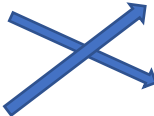
Potential payment claims:

"I am withholding pay because you only paid certain expenses"



Contractor, as trustee, has discretion to determine order and manner of payment of trust claims

"I paid you but you did not pay your subcontractors"



Contractor, as trustee, has good faith right to withhold payments

"I paid your sub, so now I'm claiming rights on the sub's behalf against you"



Owner is not the beneficiary of the trust funds paid and lacks standing

"I had to repay advances I took on the project"



Owner's voluntarily payments generally does not give it standing



Was a notice of lending filed? Was it in proper form?

Contractor's Defenses and Responses:

Owner's Acts and Claims (con't)

Potential diversion claims:

Contractor's Defenses and Responses:

"You used requisition payments on other improvement costs of the job"



Contractor may designate payments for trust claims
Not a diversion claim so long as directed to improvements

"You are not keeping separate payment accounts"



Not required, so long as account in Contractor's name and books and records properly kept

Owner's Acts and Claims (con't)

Potential diversion claims:

Contractor's Defenses and Responses:

"You used requisition payments for administrative and officer salaries"



Not allowed. Administrative expenses and officer salaries are not "costs of improvements" BUT:

- Job-site expenditures (e.g., superintendent; project manager)?
- Contractual allowances?

"You paid your overhead and profits before paying your subs"



"You used requisition payments to pay for other projects and expenses"



Not allowed but . . . lender financing multiple projects? Owner funding multiple projects? Owner commingling?

Owner's Acts and Claims (con't)

Potential funding claims:

"I have to use construction money to pay down my mortgage"



Contractor's Defenses and Responses:

Owner may not use trust funds to satisfy prior existing bank loan

"My bank is holding my funds"



Owner may not pledge trust funds to other who is not a beneficiary; owner remains trustee

Subcontractor's Acts and Claim

Potential payment claims:

Contractor's Defenses and Responses

Is this a recognized "subcontractor" of the contractor?

"I was not paid for the work performed"

Is the claim timely made?

Has owner paid the contractor?

Is there a good faith basis to withhold payment?

"The owner guaranteed I would be paid first"

Has the contractor prioritized and determined payments?

There is no privity between owner and subcontractor

Subcontractors' Acts and Claims (con't)

Subcontractor has or may allege:

"I am entitled to all the books and records on the project"



"I am entitled to an itemized statement which Contractor never provided"



Contractor's Defenses and Responses

A formal request for books/records or itemized statement must be made

- In writing
- 10 days notice
- No more than once monthly
- Describing the improvement and nature of trust claim

Mechanics Liens in Bankruptcy

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Three Steps



- File a Proof of Claim
- Determine Priority in Payment
- Analyze the Automatic Stay
 - Debtor is a project owner
 - Debtor is a general contractor
 - Debtor is a subcontractor or materialman

File a Proof of Claim

Protect your interests by filing a Proof of Claim form.

Filing a claim and indicating you are a secured creditor to protect your rights to payment.

The form can be found at:

https://www.uscourts.gov/sites/default/files/form_b_410_16.pdf



Determine Priority for Payment

- A mechanics lien moves you to the front of the line.
- It elevates you from a general unsecured creditor to secured status (the best!)
- You get paid before taxes, employee wages and general unsecured creditors.
- Is there a secured creditor in line ahead of you?
 - Mortgages
 - Judgments
 - Other Mechanic Lienors



How to Navigate the Automatic Stay

The automatic stay is one of the primary benefits of bankruptcy. It prohibits creditors from (among other things):

- Commencing or continuing litigation against the Debtor.
- Enforcing a judgment against the Debtor or the Debtor's property.
- Obtaining possession of property of the Debtor.
- Creation, perfection, enforcement of any lien.



The Debtor is a Project Owner

When a project owner files for bankruptcy, the automatic stay protects the project owner.

There are exceptions.



If you have not yet perfected your mechanics lien, you may do that by filing a Notice of Perfection of Lien with the Bankruptcy Court within the time period that you would have been permitted to commence an action to foreclose your lien under state law. 11 U.S.C. Section 546(b)

The Debtor is a Project Owner

Your lien will be preserved unless:

- the Trustee abandons the property
- the bankruptcy case is dismissed
- the automatic stay is lifted



If any of those things happen, you have 30 days to act.

The Debtor is a Project Owner

Consumer Debtors

Chapter 7:

An unperfected mechanic lien is a general unsecured debt that can be discharged.

A perfected mechanic lien is not discharged.

Chapter 13:

A mechanic lien can be paid over a 3-5 year period under a Plan.



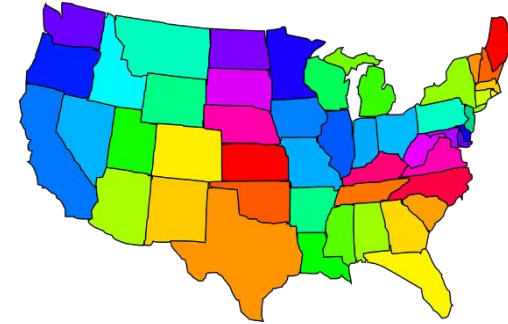
The Debtor is a General Contractor

- The filing of a mechanic lien attaches to the owner's property, not the general contractor's property.
- Do you have the green light to file a mechanic lien against the owner's property if the general contractor is the Debtor?
- The answer: It depends.



The Debtor is a General Contractor

It depends on what state you're in.

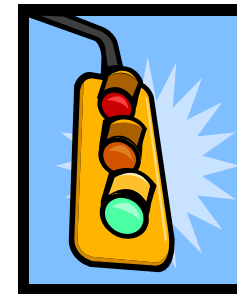


If the state's lien law relates back to a period before the bankruptcy (ie., when construction started), you can file a mechanic lien against the project owner even though the general contractor who owes you money is in bankruptcy.

If the state's lien law does not relate back to before the lien was filed, you cannot file a mechanic lien against the project owner after the general contractor who owes you money files for bankruptcy.

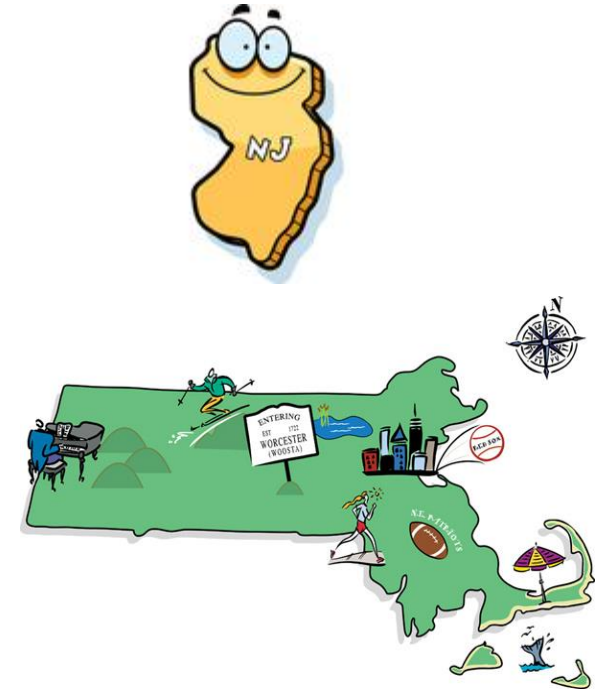
The Debtor is a General Contractor

- In New York, a mechanic lien relates back to the date the underlying debt was created.
- You have the green light to file a mechanic lien against the project owner.



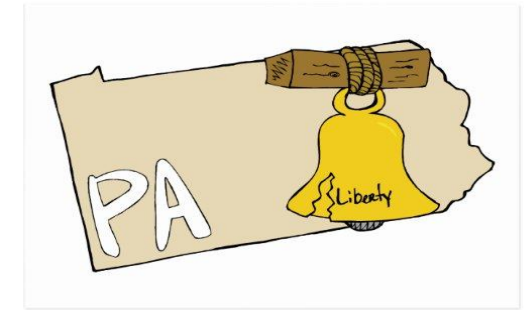
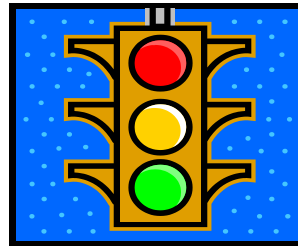
The Debtor is a General Contractor

- In New Jersey and Massachusetts a mechanic lien does not relate back to a period prior to perfection of the lien.
- You cannot file a mechanic lien against the project owner.



The Debtor is a General Contractor

- In Connecticut and Pennsylvania, a mechanic lien relates back to the date the underlying debt was created.
- You have the green light to file a mechanic lien against the project owner.



The Debtor is a Subcontractor

If you are a subcontractor of the subcontractor, the same rules apply as for subcontractors of general contractors.

The subcontractor/debtor may pursue its own rights to collection and file a mechanic lien without having to address the automatic stay.



Questions?

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