CONSTRUCTION RISK MANAGEMENT REPORTER

ERNSTROM & DRESTE LLP

ContrACT

SPRING 2025 ISSUE 36

Lien Law Trust: Paying Contractor Stands In Shoes Of Trust Beneficiaries It Paid

MICHAEL F. HIGGINS

In an uncommon but successful use of New York's trust fund laws,[1] a general contractor forced to pay twice for supplies was entitled to obtain trust funds from the subcontractor that had failed to pay them the first time. The case[2] confirmed the contractor's standing to assert trust fund diversion claims against the sub, finding it was a subrogee of the trust beneficiaries it paid, thus "standing in the shoes" of those beneficiaries under the legal doctrine of equitable subrogation.

As most contractors know, the trust fund laws are meant to ensure that construction funds are used to pay for the construction of the intended project before they become available for other uses or projects. Any payments from an upstream party are automatically designated as "trust funds" to be used for the benefit of statutory beneficiaries. All parties, including owners, contractors, and subcontractors are required by the Lien Law to properly manage and account for trust funds and must document payments to specific project expenses. Use of those monies for any other purpose is a trust diversion permitting recovery against the diverter, including against corporate principals

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Quote's Arbitration Clause Enforceable, But PPA Not So Much

NELL M. HURLEY

A concrete subcontractor was required to arbitrate a non-payment claim asserted by its materials supplier after a New York trial court determined that an unsigned quote was an enforceable contract, including the arbitration agreement it contained.[1] The court also held, however, that the supplier's failure to comply with its obligations under the Prompt Payment Act[2] ("PPA") precluded the arbitration of those claims. The case teaches important lessons for those on either side of such disputes.

The matter arose from a $9.2 million construction project in Brooklyn, New York, where the concrete subcontractor ("Sub") performed excavation, foundation and superstructure work. Sub had solicited a quote in January 2022 from a concrete supplier ("Supplier") to provide the concrete. The quote was never signed by the parties or otherwise updated to delete the large "DRAFT" watermark that appeared across its pages. Nonetheless, Supplier provided the concrete that Sub integrated into the project over the next year or so. Ultimately, the project's general contractor failed to pay Sub over $3.5 million in contract balance and, in turn, Sub failed to pay Supplier for nearly $300,000 of the concrete it supplied.

In August 2023, Supplier commenced an arbitration, asserting claims for payment under the PPA and for breach of contract under the quote document calling it a purchase order.[3] Soon after, Sub petitioned the court for an order staying the arbitration, arguing that there was no enforceable contract and that the PPA did not apply.

The court observed that, despite the broadly drafted PPA provisions in favor of arbitrability, an arbitration claim alleging violation of the PPA requires that the prerequisites of § 756-b(3) be satisfied. Only after that occurs can the claim proceed to arbitration where the non-paying party may raise defenses to support its non-payment, said the court. With no evidence of Supplier's service of a written complaint upon Sub, or of the required settlement efforts, the court found that the prerequisites were not met, Supplier's claims were outside the ambit of the PPA and thus were not arbitrable.

Regarding Supplier's common law contract claims, the court ruled differently, finding that the claims were arbitrable because "the quote became a valid contract despite the absence of the parties' signatures." The court observed that the quote states that it "becomes a valid contract upon signing and/or acceptance of materials ordered by [the Sub]." In addition, it was undisputed that Sub ordered and received concrete prior to the quote's expiration date, with the parties operating under its terms regarding price and delivery. Thus, concluded the court, the quote became a valid, binding contract upon [Sub's] acceptance of the concrete. The court stated:

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> "Although [the law] requires that an agreement to arbitrate be in writing, there is no requirement that the agreement be signed, so long as there is other proof that the parties intended to be bound by documents containing arbitration obligations."

Since the Sub did not dispute the concrete delivery, price, or assert issues with the amount or quality of the concrete, the court found that Sub intended to be bound by the quote, including the arbitration clause.

Despite public policy favoring arbitration, non-signatories are not generally subject to arbitration agreements, the court acknowledged, but it also ruled that the question of arbitrability for such non-signatories was a threshold issue to be determined by the court. Relying on a limited theory that allows the binding of non-signatories to arbitration, the court held that the direct benefits estoppel theory applied. Under that theory:

> "A non-signatory may be compelled to arbitrate where the non-signatory 'knowingly exploits' the benefits of an agreement containing an arbitration clause and receives benefits flowing directly from the agreement."

The court found that the Sub derived a direct benefit from the unsigned quote, receiving concrete per its terms, all in furtherance of Sub's project work. Sub was thus estopped (precluded) from avoiding arbitration of the contract claims and the stay of the arbitration was denied.[4]

This case is an example of the constant tension between broad public policy in favor of arbitration, the legal principles that require certain limitations on that policy, and narrow exceptions to those limitations. For contractors and suppliers, the lessons are evident: (1) Under the PPA, compliance with explicit statutory notification by written complaint to the adverse party and seeking dispute resolution MUST be demonstrated or the expedited arbitration option is lost; and (2) While an enforceable agreement to arbitrate generally requires a signed document demonstrating both parties' assent, there are limitations. If parties operate under an unsigned purported agreement, as happened here, it can and will be enforced as a contract, including its arbitration clause. E&D

1 *SEG Servs. Corp. v. Smyrna Ready Mix Concrete, LLC*, 2024 WL 1659730 (N.Y. Sup.), 2024 N.Y. Slip Op. 31389(U)(Trial Order) (Sup Ct, Kings County 2024).

2 N.Y. Gen. Bus. Law § 756-b(3) authorizes arbitration of non-payment claims where the aggrieved party has delivered a written complaint as specified to the non-paying party and made efforts to resolve the claim.

3 The Sub referred to the quote document as a supply agreement.

4 Adding stress to the situation, the arbitrator and court concurrently considered the questions of arbitrability of the two types of claims. Only a last-minute temporary stay of the arbitration prevented the likely waiver of Sub's right to litigate by participating in the arbitration prior to the court's determination. The arbitrator agreed that the contract claims were arbitrable and that PPA claims were not but added that it would be "illogical" to force Supplier to litigate PPA claims in court.

L to R, Ernstrom & Dreste's Cavan Boyle, John Dreste, and Brian Streicher with Anchin's Brian Sanvidge. The foursome participated in Gilbane's 16th Annual Upstate New York Charity Golf Tournament held Sept 9, 2024, at Bellevue Country Club in Syracuse. E&D was a Hole Sponsor.

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individually.[3] Typically, beneficiaries are those downstream, including subs, suppliers and workers, who pursue the diverter via class action.[4]

The case here presented a different trust fund recovery scenario. The general contractor for a hotel construction project paid its HVAC subcontractor over $450,000 for advance deposits on specially manufactured equipment. No part of this sum was paid by the subcontractor to the suppliers before the sub abruptly abandoned the project. After the general contractor learned of the diversion, it was forced to pay the sub's unpaid suppliers to avoid project shutdown, delay, filing of additional mechanic's liens or payment bond claims, and its own breach of the prime contract.

The general contractor sued the subcontractor for breach of contract, fraud and Lien Law trust fund diversion.[5] The sub failed to provide proper documentation accounting for the trust funds under the Lien Law and, ultimately, the matter went to a bench trial on the trust fund diversion claims. The court ruled in favor of the general contractor against both the sub and its principal individually.

On appeal, the appellate court affirmed, finding no reason to disturb the trial court's determinations of evidence and credibility of witnesses. The court upheld the lower court's conclusion that the general contractor had standing to assert the diversion of trust assets claims based on its status as subrogee of the sub's suppliers, stating:

> "...subrogee status was established here by the trial evidence showing that [general contractor] made involuntary payments to... subcontractor's unpaid suppliers..."

Of significance to the court was the sub's inability to credibly account for the funds' whereabouts, upholding the lower court's finding that the sub failed to rebut the Lien Law presumption of diversion with dubious explanations for the absence of the required books and records.

The principal of the subcontractor was also found personally liable for knowingly participating in the trust diversion. The general contractor showed that the principal controlled the company's bank account, that money was transferred to his wife's law firm and then into the account of another company he managed. This diversion of trust assets makes any purported lack of knowledge implausible, said the court.

Despite the obvious misdeeds of the sub, its principal, and his active participation in the diversion, the court upheld the lower court's decision against imposing punitive damages, finding them unwarranted under the circumstances, apparently due to a failure of proof of criminal intent.

A contractor's options for protection against a subcontractor's intentional diversion are somewhat limited. The most important tool is to know your subcontractors, including their financial health and current workload. Be alert for unusual activities or behavior.

Here, the sub's principal opposed the contractor's standing policy of only making advance deposits directly to suppliers and ultimately persuaded the contractor to pay the funds to the sub instead. Resisting that personal appeal for such a policy exception obviously would have served this contractor better.

While the decision was a good result[6] for this general contractor, double payment situations are often a financial hardship for contractors and can be financially devastating.[7] Many general "best practices" may help with early detection of a sub's diversion, including active monitoring of sub payments and obtaining timely lien waivers. If you suspect a sub is misusing funds, pay only by joint check and seek an immediate accounting of trust funds from the sub under the Lien Law. E&D

1 New York Lien Law Art. 3-A.

2 *Flintlock Construction Services., LLC v HPH Services, Inc.*, 230 AD3d 446 (1st Dept 2024).

3 Diverting parties can also be subject to criminal prosecution.

4 Although an owner has trust fund obligations and liability regarding construction loan proceeds, the more common diverters of trust funds are contractors.

5 The general contractor also obtained assignments of claims from the suppliers, but the case focused on its trust diversion rights as a subrogee to suppliers' rights under the trust fund statutes rather than on the assignments.

6 The true quality of the result may depend on whether the sub and/or the principal has assets.

7 Use of a trust fund diversion action will typically not extend to other types of "double payment" where liability is based upon joint, vicarious or derivative liability such as prevailing wage laws or the Construction Industry Wage Theft Act.

E&D Welcomes New Office Manager

Ernstrom & Dreste is pleased to announce Erin Warr as its new Office Manager. Erin will guide the critical day-to-day management functions previously administered by Clara Onderdonk, CLM®, who recently retired after a career of nearly 40 years with the firm.

Erin brings two decades as a legal professional to the position, encompassing both direct client-facing duties and business administration and management obligations, including human resources. Her vast and proficient skill set, and her positive professional energy, inform Erin's demonstrated leadership, financial, and administrative capabilities to successfully manage the business of the firm with the highest professional standards.

Erin Warr

925 Clinton Square
Rochester, New York 14604

Visit us online at:
WWW.ERNSTROMDRESTE.COM

Ernstrom & Dreste, LLP also publishes the Fidelity and Surety Reporter. If you would like to receive that publication as well, please contact Jenna Ellis at jellis@ed-llp.com. Copies of ContrACT Construction Risk Management Reporter and The Fidelity and Surety Reporter can also be obtained at Ernstrom & Dreste, LLP's website (ernstromdreste.com).

FIRM NEWS

Brian Streicher and Cavan Boyle attended the AGC's Surety Bonding and Construction Risk Management Conference in Bonita Springs, FL, January 27-29, 2025.

Kevin Peartree attended the 2024 AGC NYS/Suit-Kote Construction Industry Conference in Saratoga Springs, New York, held December 10-12, 2024. E&D was a Keynote Sponsor.

Brian Streicher was a featured speaker at Syracuse Surety Association's 2024 Surety Day on November 6, 2024, presenting "*New York Prevailing Wage Law and Certified Payrolls, 2024/2025 Update.*"

Clara Onderdonk, Certified Legal Manager (CLM)®, recently retired from E&D after nearly four decades of exemplary service and commitment to the firm.

E&D plans to transition from our printed format newsletters to a digital-only format. If you want to ensure receipt of the digital version, please email Jenna Ellis at Jellis@ed-llp.com. Email addresses will only be used for newsletter distribution.