New York law provides an important safeguard to protect the rights of those who provide labor and materials for improvements of real property. Specifically, the trust fund is a tool created by New York’s Lien Law, in addition to the mechanic’s lien, to ensure payment for such improvements. Particularly, because of the prospect of personal liability for owners and officers of corporate contractors and even criminal responsibility, the trust fund provisions of Article 3-A of the Lien Law are effective and must be taken very seriously.

The trust fund provisions provide that all funds paid to an owner, contractor or subcontractor for the improvement of private or public real property constitute trust funds that must be held by the party receiving them as trustee on behalf of the parties who provided the labor and materials for the improvement of the property. Not all funds which come into the hands of a builder constitute trust funds. Only the monies specified under the Lien Law – an owner’s, contractor’s or subcontractor’s trust – constitute trust funds.

Essentially, an owner’s trust consists of loan and mortgage proceeds and other monies intended to be used to improve real property. A subcontractor’s trust consists of proceeds paid under a contract for work performed or a second project (Project B). A separate trust is created when funds are received for each contract providing for the improvement of real property. For purposes of Article 3-A of the Lien Law, Project A and Project B are separate projects, even where both projects involve the same parties.

Problems arise and liability is imposed under the Lien Law when trust funds are diverted from the trust beneficiaries protected under the statute. Any payment of trust assets for a purpose not allowed by the statute is a diversion and liability will be imposed on both the trustee and the transferee (the person who improperly received the trust funds). Indeed, liability will be imposed regardless of the good faith of the trustor or transferee and even if the transferee is actually owed money by the trustee. Once a diversion is established, a beneficiary may obtain an accounting, recover the diverted trust funds, damages for breach of trust, attorneys’ fees and punitive damages if it can be shown that the trustee acted in flagrant disregard of the Lien Law’s trust fund provisions.

Most people assume that forming a corporation and operating in the corporate form shields them and their assets from personal liability. However, where the trustee or transferee of diverted trust funds is a corporation, the directors, officers, directors and shareholders of the corporation will be held personally liable for the diversion if it is shown that those individuals had knowledge that the monies transferred constituted trust funds or actively participated in the diversion. In order to establish personal liability, it is not necessary to prove actual knowledge that the monies were trust assets; proof of facts that would put a reasonable person on notice that a transfer involves trust funds will suffice. Lastly, a diversion by a trustee or a corporate trustee’s officers, directors or agents constitutes the crime of larceny under the Lien Law. While prosecutions under the criminal provisions of the Lien Law are rare, the very existence of those provisions underscore the importance placed by the State of New York on the public policy of protecting beneficiaries of statutory trust funds.

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