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Improperly using construction project funds is a crime in addition to being subject to civil penalties

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Article 3-A of the Lien Law of the State of New York (Article 3-A) regulates the use of funds received by an owner, general contractor and subcontractor in connection with a construction project. These "trust funds" must be used to pay for the costs of the construction project and cannot be used for any other purpose until all costs of the project are paid in full. The owner is the trustee of the trust fund created when a building loan is executed to which the general contractor is the trust fund beneficiary. Likewise, the general contractor is the trustee of the trust fund of the proceeds paid by the owner to the general contractor to which the subcontractors are the trust fund beneficiaries. Each trustee has the obligation to make sure that the trust fund proceeds are disbursed for trust fund purposes.

There are essentially three penalties for diverting trust funds. First, the individual who knowingly uses the loan proceeds to pay debts other than those for the cost of improvement, or receives the diverted trust funds knowing that they were trust funds, will be liable to the claimant (beneficiary) for the amount of the claim. Second, if the diversionary acts are egregious, the court may impose punitive damages against the individual. Third, Article 3-A provides that an officer, director or agent of the trustee (i.e., the owner) who applies or consents to the application of trust funds for any purpose other than the trust purposes of the trust is guilty of larceny and punishable as provided in the penal law.

It is this third penalty that has gained momentum over the last several years. Improprieties committed by contractors in the construction industry have led to more stringent requirements by both government agencies as well as private owners. However, the biggest change seen due to these improprieties is the proactive nature of the district attorneys who have the power to indict the principals of construction companies for the diversion of trust funds. In addition to the personal liability of the principals of the construction companies, pursuant to section 79-a of the lien law, the diversion of trust funds is larceny. Several years ago the district attorneys only prosecuted diversion of trust fund cases for the most egregious cases. However, we have seen over the last few years that the monetary threshold to cause the district attorneys to indict has decreased substantially.

Moreover, subcontractors and home owners have been able to use the district attorneys' offices as a weapon against those construction company principals whose companies have no money to satisfy a civil judgment. Instead of hiring and paying an attorney tens of thousands of dollars to obtain a worthless judgment against the company and/or the individuals, the victims of the diversion allow the district attorney to do their bidding and save the money they would have otherwise spent in bringing and maintaining the civil action. All the victim has to do is file a criminal complaint with the district attorney. Then, the district attorney commences its investigation. Now, the diverting party is suddenly faced with the prospect of being indicted by a grand jury, a costly criminal trial and the possibility of jail time. If the district attorney's investigation leads to a determination that there has been a diversion of trust funds, the diverting party is indicted and arrested.

What does the diverting party do? The old fashioned option of waiting for the beneficiary/victim to bring a civil action and put up a defense is off the table. The diverting party has no choice but to spend the tens of thousands of dollars on criminal defense and hopefully end up with a defense verdict. So, how does the diverting party avoid the foregoing? One way, if agreed to by the district attorney and the victim, is restitution; meaning, paying back the victim the sums diverted. Thus, the victim of the diversion can obtain his or her intended result without spending any money on an attorney.

It is clear that the penalties for diverting trust funds are severe and must be avoided. Relying on a civil defense to prove that you did not divert trust funds or delay matters to cause the plaintiff to expend attorneys' fees in an attempt to dissuade them from maintaining a lawsuit may not be the way out if the district attorney decides to indict the diverting party. Simply telling the beneficiary that you have no money or that you will declare bankruptcy will not matter if the victim files a criminal complaint. The bottom line is that criminal prosecution by district attorneys for the diversion of trust funds is on the rise and potential incarceration is a real possibility.

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