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Texas Construction Trust Fund Act: Avoiding the potential liability you never knew you had

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The Texas Construction Trust Fund Act is a fairly little known but very important statute for the construction industry.

Because virtually every contractor in the industry is either making or receiving construction payments (or both), familiarity and compliance with the Act's requirements can prevent some major headaches down the road.

The Construction Trust Fund Act, found in Chapter 162 of the Texas Property Code, was enacted to give protection to materialmen (in addition to the protections they receive under the lien statutes), and is to be broadly construed.

It establishes that construction payments and loan receipts that are made for the improvement of specific real property in this state are trust funds. A contractor, subcontractor, or owner who receives these funds or has control of them is a trustee of the funds. A trustee who, intentionally, knowingly, or with intent to defraud, retains, uses, or otherwise diverts trust funds without first fully paying all current or past due obligations to the beneficiaries of the trust funds has "misapplied" the funds.

So far, this probably just sounds like common sense and good business practices.

It might be, but penalties for failing to maintain the Act's requirements can be pretty harsh. A trustee who misapplies trust funds over $500 in violation of the Construction Trust Fund Act commits a Class A misdemeanor. If the trustee misapplies those trust funds with intent to defraud, they may be guilty of a third-degree felony.

Misapplication of trust funds can also create civil liability – and hence, litigation. Because the holder of the construction payment or loan receipts is a trustee, there may be a fiduciary relationship with the beneficiary – at least with respect to the trust funds.

Fiduciary relationships bring with them heightened duties, including loyalty and the utmost good faith, candor, integrity of the highest kind, and fair and honest dealing. This is notable because an intentional breach of fiduciary duty opens up the possibility for punitive damages.

One unique thing about the Construction Trust Fund Act is that it creates the potential for personal liability.

Trustee status does not stop at the corporate veil. Rather, the Act specifically states that an officer, director, or agent of a contractor, subcontractor, or owner who receives trust funds or who has control or direction of them can be a trustee.

Texas courts have been willing to find individuals who have control or direction of trust funds and misapplied them personally liable, even if they were acting on behalf of their company.

There are affirmative defenses to claims of misapplication of trust funds.

It is a defense that the trust funds were used by the trustee to pay its actual expenses directly related to the construction or repair of the improvement or that they have been retained by the trustee, after notice to the beneficiary, as a result of the trustee's reasonable belief that the beneficiary is not entitled to the funds.

It is also a defense that the trustee paid the beneficiaries all trust funds they were entitled to receive no later than 30 days following written notice to the trustee of the filing of a criminal complaint or other notice of a pending criminal investigation.

The Texas Construction Trust Fund Act underscores the need for sound business practices when it comes to handling of construction funds and payment to contractors and subcontractors.

If funds are being held back pursuant to an affirmative defense in the Act, it is particularly important to document this fact and advise, in writing, the party who is expecting payment.

There are serious potential penalties, both civil and criminal, for failing to comply with the Act.

However, knowing your duties and obligations in advance will help you avoid liabilities down the road.

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