



Who Owes Whom?

> ‘Trust-Fund’ statutes prevent contractors from exercising their right of set-off in some northeast states. That is reason enough for a wise contractor to keep up with local laws.

How often do you work with the same subcontractors on projects in a given region? Have you ever found yourself owing a subcontractor money on one project, but due a credit from that same subcontractor on a different project? The easiest way to deal with such a scenario is obviously to “set-off” the amount of the credit against the amount due. Set-off is a mechanism that allows a contractor to deduct damages caused by a subcontractor on one project from payments due to that subcontractor on another project. However, contractors wishing to do so must be aware of “trust-fund” statutes that have been enacted by some states.

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Several states have enacted construction trust-fund statutes in an attempt to ensure that subcontractors – and in some cases, sub-subcontractors and suppliers – are paid monies owed to them for labor and/or materials supplied to particular construction projects. The statutes create a “trust fund” made up of monies paid by the owner for work on the project, held by the contractor, to pay those subcontractors performing work and/or supplying materials to the project.

The institution of trust-fund statutes in many states has created a unique legal situation, preventing contractors from exercising the right of set-off. New York and Maryland have enacted such stat-





utes. New Jersey has two trust fund statutes. Pennsylvania, Delaware, Ohio and West Virginia have yet to do so.

The New York Distinction

New York courts have drawn a distinction between amounts that arise out of the same project and set-off amounts from unrelated projects. New York's Lien

Law has created a statutory scheme that creates a so-called trust fund where any payments received by a general contractor on a project for the improvement of real estate are treated as the assets of a trust. The beneficiaries are the entities that provided the labor and materials for the project. The purpose of this statute is to ensure that the funds paid to a contractor for its involvement in a construction project are applied to pay its subcontractors and suppliers for the labor and materials used on that particular project.

The New York courts have applied that statute in the case of *Universal Maintenance Inc. vs. Amherst Painting Inc.* In *Universal Maintenance*, the general contractor, Amherst, claimed set-offs against money owed on a particular project for amounts that Universal allegedly owed to Amherst stemming from deficiencies on other projects. The court held that Amherst was not permitted to apply as set-offs the funds owed by Universal under separate contracts. The court reasoned that offsetting claims arising out of the same project are relevant in determining the size of the trust fund to which a subcontractor is entitled.

However, claims arising from other projects lack mutuality; Universal's claim was for monies held in trust while Amherst's claim was for an unsecured debt. Therefore, the claims on unrelated projects could not be applied to set off the amounts held in trust and instead had to be pursued in a separate action. Although this scenario ensures that funds paid to a contractor for its involvement in a construction project are applied to pay for the labor and materials used on that project, it has the potential to cause near-duplicative litigation that requires the parties to litigate claims in separate lawsuits, which creates an additional layer of cost for the parties. Maryland's trust fund statute is nearly identical to New York's in its application, as is New Jersey's as it applies to public projects.

In contrast, Pennsylvania, Delaware, Ohio and West Virginia do not have

statutes that convert funds paid to the general contractor into a trust fund held for the benefit of subcontractors. In fact, each of these states has more liberal set-off requirements, arising from the common law definition of the term, and allowing general contractors in these states to make payments to a subcontractor, which allow setting off the debt that the subcontractor owes on other projects.

In Pennsylvania, for example, "the right of set-off [also called 'offset'] allows entities that owe each other money to apply their mutual debts against each other, thereby avoiding the absurdity of making A pay B when B owes A." (In re Anes, 195 F.3d 177, 182 (3d Cir. 1999) quoting *Citizens Bank v. Strumpf*, 516 U.S. 16, 18 [1995]) Courts in Delaware and West Virginia have made near identical legal statements on this same issue. Therefore, in these states, the distinction between set-offs arising from the same contract and those arising from other contracts is irrelevant, enabling a general contractor to make payments to a subcontractor that allow setting off the debt that the subcontractor owes on unrelated projects.

The lesson to be learned from the trend toward the enactment of trust-fund statutes is that, as a contractor, you should be aware of the provisions of the trust-fund laws in jurisdictions in which you perform work. Although no courts in the northeast region have yet dealt with the issue, a sophisticated contractor would be wise to include appropriate contractual provisions to allow for set-off even if a given state has enacted a trust fund. The inclusion of such a provision may allow a contractor to at least argue that it can continue to set off amounts from other projects. ☺

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