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**USE OF CONSTRUCTION TRUST FUND STATUTES
AND THE MISAPPLICATION OF FUNDS**

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USE OF CONSTRUCTION TRUST FUND STATUTES AND THE MISAPPLICATION OF FUNDS DOCTRINE IN DEFENSE OF PAYMENT BOND CLAIMS

INTRODUCTION.¹

In many states, construction trust fund statutes require contractors receiving progress payments from a public owner² to utilize those payments to satisfy claims of subcontractors and materialmen by impressing a trust on such funds in the hands of the contractor and third parties who have knowledge of their source. When, for example, a materialman has such knowledge, a trust fund statute may obligate it to credit payments from the contractor to invoices for materials supplied by it to the public project rather than to invoices for other projects. Even in the absence of construction trust fund statutes, courts in many jurisdictions have found an equivalent duty under a common law doctrine sometimes called the misapplication of funds defense. These statutes and the common law doctrine can be critical tools for use by a surety in the defense of payment bond claims.

Excellent papers have analyzed and surveyed trust fund statutes and cases in connection with the surety's interest in contract funds in the hands of materialmen and other third parties.³ No attempt will be made here to re-canvass the law of the various jurisdictions. Rather, this paper will focus on the nuts and bolts application of such principles in the defense of payment bond claims and will illustrate how trust fund statutes and the related common law defense can be utilized as important means of limiting a surety's payment bond exposure.

I. THE FACTS

A payment bond claim defended in our office will serve as an illustration case. The facts were developed as follows: A materialman presented claims totaling \$425,000 against five payment bonds issued by the surety on behalf of its principal, a general contractor. The bonded projects all involved public projects in the state of New York. The principal confirmed the amount of the materialman's claim, and invoices and delivery tickets corroborated shipment of the materials to the applicable sites. The project architects confirmed the incorporation and satisfactory quality of the materials. The claim was presented well within the limitations provisions of the bonds, and the principal advised the surety of its inability to make payment. Thus, on its face, the claim appeared to be valid with no obvious defenses available to avoid or limit liability under the surety's payment bond. Moreover, none of the projects had been completed, and the remaining contract funds and retainage on each were insufficient to fund completion of

¹ This paper is an update of an article with the same title prepared by Armen Shahinian and James D. Ferrucci of Wolff & Samson PC for the Northeast Surety & Fidelity Conference, November 7, 1991; this update was prepared by the original authors with the assistance of Joseph Monaghan.

² Some state statutes extend this requirement to private projects.

³ See, e.g., K. McNaughton and M. Jetton, Surety's Rights to Contract Funds Under Trust Fund Provisions in Indemnity Agreements and Trust Fund Statutes, Surety Claims Institute, June 24-26, 1999; Hartigan, Source of Funds with Which Payment is to be Made as Affecting Application, 9 Forum 543 (Spring 1974) (hereinafter cited as Hartigan); J. Haris, Rights of a Surety to Funds Paid by the Owner-Obligee to the Contractor-Principal or What to do After the Chicken Has Flown the Coop, 1984 Mid-Winter Meeting, A.B.A. T.I.P.S. Fidelity and Surety Law Committee (January 27, 1984); J. Bruen, Trust Fund Statutes - - The Rights of Contractors, Laborers, and Materialmen Thereunder and Their Impact on Sureties and Others, 1983 Mid-Winter Meeting, A.B.A. T.I.P.S. Fidelity and Surety Committee (January 28, 1983).

performance, no less reimbursement of payment bond claims.

We then asked each obligee to furnish a list of all payments made on the bonded contracts by both date and amount. We also obtained from the materialman his complete account records with respect to the principal, which listed all invoices rendered on all projects, whether bonded or not, and all payments made by the principal to the materialman from the date of the earliest bond. Finally, we reviewed the principal's checking records, including both deposits and checks.

As a result of this additional investigation, we were able to determine that two checks from the obligee with respect to Bonded Project A, totaling \$160,000, had never been deposited in the principal's bank account. Rather, those checks, which had been made payable jointly to the principal and materialman, had been endorsed by the principal over to the materialman and deposited directly by it. At that time, the invoices for materials supplied to the principal for Bonded Project A totaled \$120,000. In accordance with its customary practice, the materialman credited the proceeds of the joint checks to the principal's oldest unpaid invoices. That resulted in \$150,000 of the \$160,000 being applied to pay off older invoices for non-bonded projects, while only \$10,000 was credited to the invoices relating to Bonded Project A. That application reduced the amount of the latter invoices from \$120,000 to \$110,000. Thereafter, the materialman continued to supply materials to the principal for Bonded Project A, and by the time the claim was submitted to the surety, \$200,000 of the \$425,000 claim was for materials supplied to Bonded Project A.

With respect to Bonded Projects B and C, the principal deposited progress payments received from the obligees into its general checking account. Examination of the obligees' payment records, the principal's checking records, and the materialman's computerized monthly statements of account established a pattern whereby immediately upon receipt by the principal of several substantial payments from the obligees on those projects, substantial payments were made to the materialman by the principal from its general checking account. Again, those payments were credited by the materialman to the principal's oldest outstanding invoices which were for materials supplied to non-bonded projects. Approximately \$180,000 of payments by the principal fit this pattern rather precisely, with other payments being less clear.

The principal was then interviewed, and he stated that at various times he had been pressed for payment by the materialman to reduce the outstanding balance in his account. He stated that he had on numerous occasions specifically told the materialman's credit manager that he was expecting substantial payments from Bonded Projects B and C on pending requisitions and that immediately upon receipt of such payments he would make substantial payments to the materialman in reduction of his outstanding account balance. He further advised that such promises were kept and payments made from the proceeds of such requisitions. Moreover, the materialman's credit manager had on occasion telephoned the project architects to corroborate the principal's representations that substantial payments were due shortly from the obligees.

As a result of all of the above, we were able to demonstrate through unchallenged documentary evidence that, with respect to Bonded Project A, the materialman had received \$160,000 of contract proceeds yet had applied only \$10,000 to its invoices for that project. We were further able to demonstrate that, with respect to Bonded Projects B and C, the materialman had received \$180,000 which the principal's checking records showed had come from the proceeds of those projects. Moreover two different witnesses could testify that the materialman's

credit manager knew that the principal's payments were being made from the proceeds of Bonded Projects B and C.

Despite those facts, the materialman applied the payments to its oldest outstanding invoices and not to the invoices for materials supplied to Bonded Projects B and C.

II. THE TRUST FUND STATUTE.

The illustration case presented three issues. Each will be analyzed in turn.

Issue 1. If the materialman knew that payments received by it on account were made from proceeds received by the principal from the bonded contracts, must it apply those payments to invoices relating to the bonded projects in the absence of any direction to do so by the principal?

In the state of New York, Article 3A of the Lien Law imposes trust obligations as to the proceeds of funds due or earned with respect to contracts for public improvements.⁴ Under Section 2 of the Lien Law, "public improvement" is defined as "an improvement of any real property belonging to the state or a public corporation."⁵ Section 70 of the Lien Law sets forth the definition of trusts and provides in pertinent part:

§70. Definition of trusts.

1. The funds described in this section received by . . . a contractor under or in connection with a contract . . . for a public improvement in this state . . . shall constitute assets of a trust for the purposes provided in section seventy-one of this chapter.

...

3. Every such trust shall commence at the time when any asset thereof comes into existence, whether or not there shall be at that time any beneficiary of the trust. . . . The trust of which a contractor or subcontractor is trustee shall continue with respect to every asset of the trust until every trust claim arising at any time prior to the completion of the contract or subcontract has been paid or discharged, or until all such assets have been applied for the purposes of the trust. . .

....

6. The assets of the trust of which a contractor is trustee are the funds received by him and his rights of action for payment thereof

(a) under the contract for the improvement of real property, . .

⁴ N.Y. Lien Law §70 *et seq.* (McKinney 1987 & Supp. 2003).

⁵ N.Y. Lien Law §2 (McKinney 1987 & Supp. 2003).

. or the public improvement;⁶

The purposes of the trust and the identities of its beneficiaries are established in Section 71 of the Lien Law as follows:

2. The trust assets of which a contractor or subcontractor is trustee shall be held and applied for the following expenditures arising out of the . . . public improvement and incurred in the performance of his contract or subcontract, as the case may be:

(a) payment of architects, engineers, materialmen; claims of surveyors, subcontractors, laborers and materialmen;

. . . .

3. (b) With respect to the trusts of which a contractor or subcontractor is trustee, "trust claims" means claims arising at any time for payments for which the trustee is authorized to use trust funds as provided in subdivision two of this section.

. . . .

4. Persons having claims for payment of amounts for which the trustee is authorized to use trust assets as provided in this section are beneficiaries of the trust whether or not they have filed or had the right to file a notice of lien as provided in article two of this chapter or shall have recovered a judgment therefor. Where an owner becomes obligated to incur an expenditure as part of the cost of improvement, any person to whom he is so obligated is a beneficiary.⁷

Finally, Section 72 of the Lien Law provides in pertinent part:

§72. Diversion of trust funds.

1. Any transaction by which any trust asset is paid, transferred or applied for any purpose other than a purpose of the trust as stated in subdivision one or subdivision two of section seventy-one, before payment or discharge of all trust claims with respect to the trust, is a diversion of trust assets, whether or not there are trust claims in existence at the time of the transaction, and if the diversion occurs by the voluntary act of the trustee or by his consent such act or consent is a breach of trust.

Nothing in this article affects the rights of a holder in due course of a negotiable instrument or of a purchaser in good faith for value and without notice that a transfer to him is a diversion of trust

⁶ Id. §70.

⁷ Id. §71.

assets.⁸

The basic purpose behind the trust fund statute is to insure that moneys earned in performance of a contract for public improvements will in fact be used to pay the costs of those improvements⁹ and Section 72 defines a diversion of trust assets to include specifically the “application” of trust assets to non-trust purposes. As the New York Court of Appeals recently explained in RLI Ins. Co. v. N.Y. State Dept. of Labor:¹⁰

Use of trust assets for any purpose other than the expenditures authorized in Lien Law §71 before all trust claims have been paid or discharged constitutes an improper diversion of trust assets, regardless of the propriety of the trustee’s intentions.

Under Section 77 of the Lien Law,¹¹ a trust beneficiary, or a person subrogated to the rights of a trust beneficiary, may enforce its rights against any nonbeneficiary who receives trust assets with knowledge of their trust status.¹²

Applying these principles and terms of the New York Lien Law to the illustration case, one must conclude that the materialman violated the trust fund statute by applying trust funds which it knew were proceeds from contracts for public improvements to its oldest outstanding invoices which related to materials supplied on other projects. Cases in New York interpreting the trust fund provisions of the Lien Law confirm this analysis. In Tri-Boro Enterprises v. Roger & McCay,¹³ plaintiff, a material supplier to a subcontractor, brought an action to recover on a payment bond issued by defendant surety on behalf of a defendant general contractor in connection with a public contract. After the materialman made its first delivery on the project, the subcontractor paid the materialman \$12,750. The materialman applied the \$12,750 against the oldest unpaid items in subcontractor's account. In doing so, a balance of just under \$10,000 remained due from the subcontractor on the bonded project. Sometime thereafter, the subcontractor filed for bankruptcy protection. The defendants asserted that the \$12,750 paid to plaintiff by the subcontractor had originated from the public agency and flowed through the general contractor to the subcontractor and materialman. On that basis, the trial court gave judgment to the defendants.

On appeal, the Appellate Division held that any moneys received by the general contractor from the public agency and, in turn, paid by the subcontractor to the materialman were trust funds under Article 3A of New York's Lien Law. Therefore, the materialman was prohibited from applying such moneys to the oldest unpaid items in the subcontractor's account.¹⁴ The court stated:

We agree that, under Article 3-A of the Lien Law, moneys

⁸ Id. §72 (emphasis added).

⁹ Aspro Mech. Contr., Inc. v. Fleet Bank, N.A., 742 N.Y.S. 2d 361, 362 (N.Y. App. Div. 2d Dept. 2002); Allerton Constr. Corp. v. Fairway Apts., 26 A.D.2d 636, 272 N.Y.S. 2d 867 (N.Y. App. Div. 1966), appeal denied, 276 N.Y.S.2d 1025, 222 N.E.2d 745 (1966); AABCO Sheet Metal Co. v. Lincoln Center for the Performing Arts, 663 N.Y.S. 2d 490, 491 (N.Y. Sup. Ct. 1997).

¹⁰ 740 N.Y.S. 2d 272, 276 (N.Y. Ct. App. 2002).

¹¹ N.Y. Lien Law §77 (McKinney 1987 & Supp. 2003).

¹² Canron Corp. v. City of New York, 652 N.Y.S. 2d 211, 214 (N.Y. Ct. App. 1996)

¹³ 28 A.D.2d 860, 281 N.Y.S. 2d 588 (N.Y. App. Div. 1967)

¹⁴ Id. at 589-590.

received by . . . [the general contractor] as payments under its contract with the Dormitory Authority were trust funds for the payment of subcontractors, materialmen and workmen; and we hold that plaintiff [the materialman] was required to apply such funds, received by . . . [the subcontractor] from . . . [the general contractor] and paid by . . . [the subcontractor] to plaintiff, to . . . [the subcontractor's] debt for the materials to that construction project. We recognize the conflict in the cases relating to the application of payments made by a debtor (see annotations, 41 A.L.R. 1297 et seq.: 130 A.L.R. 198 et seq.: 166 A.L.R. 641 et seq.: 57 A.L.R.2d 855 et seq.). However, where trust funds are involved, we believe that the subcontractor's materialman should be required to use moneys received by the subcontractor from the prime contractor and paid by the subcontractor to the materialman to satisfy the subcontractor's debt for the job for which payment was made to the subcontractor. The materialman suffers no legitimate loss by so doing and gains no windfall at the expense of another. . . .¹⁵

It should be noted that the Tri-Boro court reversed the judgment for the defendant surety company and ordered a new trial because the surety failed to present sufficient proof that the payments by the subcontractor were from moneys received by it from the general contractor. However, no such evidentiary problem existed as to the joint checks in the illustration case because the \$160,000 in trust moneys went directly to the material supplier in the form of the obligee's joint check.

The right of the surety to obtain the benefit of New York's trust fund statute was also recognized in General Crushed Stone Co. v. State.¹⁶ There, a general contractor obtained a contract to pave two state highways. Materials were supplied to the general contractor by a materialman which had conducted business with the general contractor for many years. At issue was the liability of the general contractor's surety to the materialman for materials supplied on public jobs.

The materialman was the general contractor's primary supplier and was familiar with its affairs and financial condition. When the general contractor became financially insecure, it fell into the common pattern of paying the materialman for old bills with new moneys. The trial court found that this pattern amounted to a "complete disregard of the statutory trust provisions (Lien Law §70)."¹⁷ It further found that while at least \$200,000 was received by the general contractor for the highway jobs, no part thereof was applied by the materialman to the payment of its invoices for those jobs. The trial court concluded, and the Court of Appeals agreed, that the materialman had aided and abetted the general contractor in violation of the trust provisions of the Lien Law. As a result, it was held that under equitable principles, the materialman should not be permitted to profit from its own misdeeds, and judgment was given in favor of the surety dismissing the claim on its bonds.

¹⁵ Id. at 590.

¹⁶ 46 Misc.2d 266, 259 N.Y.S.2d 757 (N.Y. Sup. Ct. 1963), aff'd and modified, 23 A.D.2d 250, 260 N.Y.S.2d 32 (N.Y. App. Div. 1965) (awarding deficiency judgment against surety) rev'd, 19 N.Y.2d 737, 279 N.Y.S. 2d 190, 225 N.E.2d 893 (1967) (reinstating trial court judgment).

¹⁷ Id. 259 N.Y.S.2d at 759.

It should be stressed that the burden of proof is on the surety to demonstrate the materialman's knowledge that the funds being received are, in fact, trust funds.¹⁸ Moreover, Section 72 of the Lien Law specifically provides that the trust fund provisions do not affect the rights of a holder in due course of a negotiable instrument or a good faith supplier who receives funds without notice that the transfer to him is a diversion of trust assets.¹⁹ In the illustration case, however; it is clear that the materialman knew the source of the funds it was receiving, yet properly applied only \$10,000 of the \$160,000 in trust proceeds received by it through joint checks from Bonded Project A and none of the \$180,000 in payments of trust fund proceeds from Bonded Projects B and C. As a result, its \$425,000 claim must be reduced by \$330,000 -- the aggregate amount of the misapplied trust funds -- to a total legitimate claim of \$95,000.

Issue 2. When the materialman was advised that the surety was only willing to recognize \$95,000 of its claim, it responded that, even if the surety was correct as to its trust fund defense, that defense could only prevail with respect to the \$160,000 joint check payments to the extent of the outstanding invoices at the time such checks were received. Because there were only \$120,000 in outstanding invoices at the time the \$160,000 in joint checks were received, the materialman asserted that it was perfectly legitimate for it to apply the \$40,000 excess to outstanding invoices on other projects.

The materialman's position is directly contradicted by the New York Lien Law, however. Section 70.3 specifically provides that, the trust commences when any asset thereof comes into existence and "shall continue with respect to every asset of the trust until every trust claim arising at any time prior to the completion of the contract . . . has been paid or discharged. . . ."²⁰ Moreover, Section 72 of the Lien Law provides that "[a]ny transaction by which any trust asset is paid or applied for any purpose other than a purpose of the trust. . . before payment or discharge of all trust claims. . . is a diversion of trust assets, whether or not there are trust claims in existence at the time of the transaction. . . ."²¹

Accordingly, the entire \$160,000 joint check must be applied in reduction of the materialman's claim on the bonded project even though the amount of the check exceeded the amount of the materialman's outstanding invoices for the bonded project at the time.

Issue 3. Does the fact that the checks received by the principal from the obligees on Bonded Projects B and C were deposited into the principal's general checking account, and therefore commingled with other funds, preclude the surety's defense as to invoices relating to Projects B and C?

The materialman contended that because the \$180,000 was received through checks drawn on the principal's general account, the surety could not prove knowledge by the materialman of the source of the funds it received. The materialman pointed out that money is fungible and that, therefore, once it has been deposited into an account in which other funds are held, the surety cannot sustain its burden of proving that a check written on such an account constitutes trust funds.

¹⁸ See Tri-Boro, 281 N.Y.S.2d at 590.

¹⁹ N.Y. Lien Law §72 (McKinney 1987 & Supp. 2003).

²⁰ Id. §70.3.

²¹ Id. §72 (emphasis added).

Section 75 of the Lien Law provides, however, that although the contractor-trustee's records must show the allocation of all trust funds received, the trustee is not required to keep separate bank accounts for deposit of trust funds.²² This provision of the Lien Law was addressed in Fentron Architectural Metals v. Solow²³, where the court held that the trustee commingled funds and treated trust funds as running bookkeeping balances rather than as segregated accounts. In the illustration case, the surety enjoyed the benefit of (a) a clear paper trail relating to the \$180,000; (b) available testimony from the principal concerning the materialman's knowledge that payments it was receiving were trust funds; and (c) corroboration by the project architects of the materialman's knowledge regarding the source of the funds from which the materialman was being paid. Therefore, the surety was able to successfully utilize a trust fund defense to set-off the materialman's claim by the full \$180,000 paid from commingled funds.²⁴

III. THE MISAPPLICATION OF FUNDS DEFENSE.

There will be many occasions when a surety must respond to claims without the benefit of an applicable trust fund statute. Even in those circumstances, however, the surety is not at the mercy of a payment bond claimant -- such as the materialman in the illustration case -- who has misapplied payments made by the principal from funds derived from the bonded projects to debts owed by the principal for labor or materials supplied on other projects. The claimant can be expected to argue that under basic contract principles,²⁵ he is free to follow the principal's direction that the payment be applied to another account or to apply the payment as he wishes if the principal has not specified the account to be credited. Courts, however, have recognized an equitable exception to the general "rule of freedom of application" under certain circumstances when the interests of a surety are involved. This exception has been called "the misapplication of funds defense."²⁶ It has been most fully developed by federal courts in Miller Act cases where there is no trust fund statute to benefit the surety. In St. Paul Fire and Marine Ins. v. United States ex rel. Dakota Electric Supply Co.,²⁷ then Circuit Judge Blackmun, in applying the defense, stated the basic principle and articulated its rationale as follows:

Where, as here, there are outstanding two or more matured and similar obligations of a debtor to one creditor and a payment by that debtor to the creditor, the question of proper application of that payment arises. This fact situation and its variations have provoked widespread litigation and have resulted in claimed conflict in the cases. It is perhaps not incorrect to say, however, that the law today shapes up generally as follows:

²² Id. §75.

²³ 101 Misc.2d 393, 420 N.Y.S.2d 950 (N.Y. Sup. Ct. 1979).

²⁴ Trust fund statutes have been enacted in states other than New York; see e.g., Colo. Rev. Stat. Ann. §38-22-127 (2002); Mich. Comp. Laws Ann. §570-151 (2003); Neb. Rev. Stat. §52-123 (2003); N.J. Stat. Ann. §2A:44-148 (2002); Okla. Stat. Ann. Tit. 42, §152 (2002); Texas Property Code § 162, et. seq. (Vernon 1995 & Supp. 2003); see also Cal. Penal Code §484b (2003) (does not create a trust but declares illegal and wrongful diversion of construction funds).

²⁵ See, e.g., Restatement of Contracts §387 (1932). See infra p. ____ for a discussion of pertinent provisions of the Restatement of Contracts.

²⁶ United States ex rel. West Chester Electric & Electronics Co. v. Sentry Insurance, 774 F.2d 80, 84 (4th Cir. 1985).

²⁷ 309 F.2d 22 (8th Cir. 1962), cert. denied, 372 U.S. 936, 83 S. Ct. 883, 9 L.Ed.2d 767 (1963) (hereinafter cited as Dakota Electric).

(i) The payment is applied as the debtor intends and so manifests to the creditor before or at the time of the payment.

(ii) If the debtor fails so to indicate, the payment is applied as the creditor, within a reasonable time, determines.

(iii) If neither the debtor nor the creditor reasonably so indicates, the payment is applied as a just regard to its effect upon the debtor, the creditor, and third persons makes it desirable that it should be applied. This usually results in its application to the oldest unsecured account.

(iv) If the debtor is under a duty to a third person to devote funds paid by him to the discharge of a particular debt, the payment must be so applied if the creditor knows or has reason to know of that duty. This is so despite the debtor's contrary direction.

This rule of freedom of application rests upon the concept that the money which the debtor is utilizing to make the payment is his own and is free for use as he pleases. The noted exception, phrased in terms of duty, rests on equitable considerations. Examples which the cases recognize without much conflict are where the surety itself makes a payment to the debtor or where money which comes to the creditor from the debtor is the same money for the payment of which the surety is bound and the creditor knows the source of that fund.²⁸

Under the misapplication of funds defense, the surety is entitled to a reapplication or an offset of the payment that was applied to the principal's invoices for unbonded projects if the surety can show (1) that the funds paid originated from the bonded project and (2) that the materialman knew or had reason to know of the source of the payment. As is typically the case with trust fund statutes, when those facts appear, the materialman is said to have a duty to apply the payment to the principal's account for the bonded project.²⁹ Once the duty has been found to exist, it binds the materialman even if the principal gave a contrary direction. The duty is equitable in nature³⁰ and arises from the perceived unfairness to the surety of allowing the materialman unfettered discretion in the application of payments. As one court has explained:

The rationale for this rule is that it would be unfair to the principal and surety on the Miller Act bond to permit a supplier to collect old debts out of monies paid on a current government project, secure in the knowledge that he will be able to collect for the materials furnished on

²⁸ Id. at 24-25.

²⁹ It appears that most states also require a creditor to apply payments to bonded debts if he knows that the payments came from bonded transactions, see, Hartigan, supra note 2, at 556, appended Classification of Jurisdictions and cases cited therein (prepared jointly by Hartigan and Plowman).

³⁰ See, e.g., United States ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp., 378 F.2d 134, 137 (2d Cir. 1967).

the government project by filing a claim against the bond.³¹

In the illustration case, the materialman was a direct supplier to the surety's principal, from whom the materialman received the payments. Under the principle of exoneration, the principal is obligated to pay its subcontractors and suppliers, thereby relieving the surety of the burden of doing so. Moreover, under the typical indemnity agreement, the principal owes a duty to the surety to use payments from a bonded project to pay for the labor and materials furnished to that project. And courts have recognized the enforceability of those contractual trust fund provisions which have complied with the applicable state law for creation of an express trust³². For instance, the bankruptcy court in In re Alcon Demolition, Inc.,³³ held that, under New Jersey law, a trust fund provision in an indemnity agreement creates an express trust in favor of the principal's subcontractors and suppliers – and in favor of the surety to the extent of payments made by the surety – and that contract proceeds received by the principal are subject to that trust.

The cases generally proceed on the implicit assumption that if the materialman knows that there is a surety, he also knows of the principal's duty to the surety.³⁴ In many of the Miller Act cases, the materialman did not furnish supplies directly to the surety's principal, but rather it supplied a subcontractor to the principal and the subcontractor made the payment. However, the fact that the claimant is not in privity with the surety's principal makes no difference. If the materialman knew that his subcontractor's payment consisted of funds received from a Miller Act contractor, the duty can be found. As a practical matter, unless the contrary appears, materialmen are regarded as knowing that a general or prime contractor on a federal project has a surety. Thus, the statement of the factual predicate of the misapplication of funds defense is frequently abbreviated to the materialman's knowledge that the source of his subcontractor's payment was a Miller Act contractor:

[W]here a materials supplier receives funds from a subcontractor knowing that the source of those funds is the general contractor on a government project, the supplier is obligated to apply those funds to the government project account.³⁵

The cases generally agree on the abstract statement of the defense, such as that set forth above. Difficulties often arise in applying it in particular cases because the simple formulation can raise intricate factual questions. A court must ask whether payments to a materialman can be traced to funds from the bonded contract and inquire whether the materialman knew or should have known of that derivation. An opinion will occasionally analyze the derivation question independently from the knowledge question. One court, for example, found that the disputed payments could not be traced to the bonded project and therefore held that the question of the

³¹ United States ex rel. General Elec. Supply Co. v. Wiring, Inc., 646 F.2d 1037, 1040 (5th Cir. 1981) (hereinafter cited as Wiring).

³² See, e.g. Federal Ins. Co. v. Fifth Third Bank, 867 F. 2d 330 (6th Cir. 1989); In re McCormick, 283 B.R. 680 (Bankr. W.D. Pa. 2002); In re Wright, 266 B.R. 849 (Bankr. E.D. Ark. 2001); In re Smith, 238 B.R. 664 (Bankr. W.D. Ky. 1999).

³³ 204 B.R. 440 (Bankr. D.N.J. 1997).

³⁴ See, e.g., Dakota Electric, 309 F.2d at 30 (upholding the defense without a specific finding that the materialman knew of the general contractor's duty to its surety).

³⁵ Wiring, 646 F.2d at 1040.

materialman's knowledge of the derivation need not be addressed.³⁶ More commonly, courts collapse the two issues into a single inquiry. In those cases, the derivation issue is subsumed into the question whether the materialman knew or should have known of the source of the payment.³⁷

As an overall proposition, the "tracing" issue is the key to the defense. The more easily the disputed payment can be identified as being derived from funds paid under the bonded contract, the more likely that a reapplication will be required. Circumstances can arise where the requisite derivation is found but it could not be proved that the materialman knew or should have known the source of the payment to it. In those cases, it is important to note, the defense can be denied.³⁸ Very often, however, if the funds can be traced, there will be an adequate basis for showing that the materialman knew the source of the payment to him.

1. Payment by Joint Checks.

In the illustration case, the obligee for Bonded Project A issued two checks, drawn jointly to the principal and materialman, which were delivered to the materialman. The checks totaled \$160,000, but the materialman credited all but \$10,000 to older invoices for other projects.

On those facts, the surety can reasonably expect a court to require a reallocation of the proceeds of the joint checks up to the amount of the principal's account for Bonded Project A at the time of payment.³⁹ The existence of a joint check, itself, ordinarily establishes both the source of the funds used to pay the materialman and the materialman's knowledge of that source, and thus the requisite bases of the defense appear.⁴⁰ If payment is made by a check drawn by the general contractor to the subcontractor, but endorsed and delivered by the subcontractor to the materialman, one can expect a similar analysis and result.⁴¹

A joint check, however, will not guarantee success. In Koehring Co. v. United States ex rel. Hoover Equipment Co.,⁴² a Miller Act contractor issued a check drawn jointly, to the subcontractor and its materialman. The materialman, pursuant to the subcontractor's direction, applied the proceeds to the subcontractor's oldest account which, was for another project. Although it acknowledged the duty underlying the misapplication of funds defense, the court affirmed a judgment for the materialman. The court relied on the finding below that the materialman did not

³⁶ Id. at 1041-1042.

³⁷ See, e.g., Dakota Electric, 309 F.2d 22; see also Trans-American Steel Corp. v. J. Rich Steers, Inc., 670 F.2d 558 (5th Cir. 1982) (applying Georgia law).

³⁸ See Koehring Co. v. United States ex rel. Hoover Equip. Co., 303 F.2d 468 (10th Cir. 1962) (finding that the materialman had insufficient knowledge, even though paid with a joint check, because the materialman did not know that the subcontractor, the joint payee, or the contractor, the drawer of the check, were engaged in a bonded project); see also Silver Hill Concrete Corp. v. Thomason Industries Corp., 556 F. Supp. 291 (D.D.C. 1982), aff'd, 704 F.2d 1294 (D.C. Cir. 1983) (holding in part that the materialman's knowledge that the subcontractor received some funds from the general contractor on the bonded project was insufficient because the materialman could not know whether any particular payments were from funds derived from that project or from others); see also American Oil Co. v. Brown Paving Co., 298 F. Supp. 528 (D.S.C. 1969) (applying South Carolina law).

³⁹ Ordinarily, reapplication will not extend to invoices which arose subsequent to the time of payment, see Section 3, infra p. 40.

⁴⁰ See, e.g., United States ex rel. West Chester Electric & Electronics Co. v. Sentry Insurance, 774 F.2d 80 (4th Cir. 1985); see also United States ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp., 378 F.2d 134 (2d Cir. 1967).

⁴¹ See Graybar Electric Co. v. John A. Volpe Construction Co., 387 F.2d 55 (5th Cir. 1967).

⁴² 303 F.2d 468 (10th Cir. 1962).

know that either the subcontractor or the prime contractor was engaged on a Miller Act project.

2. Payments From a Commingled Account.

The joint check cases are relatively straightforward. When, however, the materialman does not receive payment in the form of a joint check or other direct payment from the obligee, the payment is not so easily traced back to the bonded contract. In the illustration case, for example, the principal made payments to the materialman of \$180,000 by checks drawn on its general checking account. The surety nevertheless asserted that those payments originated from funds paid by the obligees for Bonded Projects B and C and should have been applied to invoices to the principal for those projects. Unlike the joint check case, neither the source of the funds nor the materialman's knowledge of the source is indisputably established by the payment itself. The fact that the obligees' payments were deposited into the principal's general checking account and commingled with other receipts means that the surety is required to marshal additional proofs to show that the payments to the materialman are traceable to the bonded contract. Its case becomes more difficult, and the outcome less certain.

Courts have taken conflicting analytical approaches to this kind of case with inconsistent results. A comparison of the two federal circuit court opinions illustrates the problems. In St. Paul Fire and Marine Ins. v. United States ex rel. Dakota Electric Supply Co.,⁴³ reapplication was required, while in United States ex rel. General Electric Supply Co. v. Wiring Inc.,⁴⁴ the defense was denied. In both cases: (1) the materialman supplied electrical equipment to a subcontractor of a general contractor on Miller Act project; (2) the subcontractor made payments to the materialman from the subcontractor's general operating account; (3) at the direction of the subcontractor, the materialman applied payments to accounts of the subcontractor other than that for the bonded contract; (4) the amount of the payments received by the subcontractor from the general contractor was a small fraction of the subcontractor's total receipts during the relevant period (10% to 11% in Wiring, and 3% in Dakota Electric); (5) during that period, the subcontractor was engaged in projects other than that bonded by the general contractor's surety, and the subcontractor received electrical supplies from both the materialman and other suppliers for its other projects; and (6) the general contractor's surety asserted the misapplication of funds doctrine in defense of the materialman's claim for the balance due for equipment supplied to the bonded project. In each case, the court found that the disputed payments could not be specifically traced to the general contractor's payment to the subcontractor, but said that the party asserting the defense was not "required to trace exact funds."⁴⁵ Despite the similarities, the court in Wiring found the inability to trace fatal and refused to require reapplication, while the court in Dakota Electric came to the opposite conclusion.

In Wiring, the materialman had supplied electrical equipment to the subcontractor for the same general contractor on two federal projects bonded by the general contractor's surety. For both projects, there was a series of payments from the general contractor to the subcontractor and a corresponding series of payments from the subcontractor to the materialman. The general contractor and its surety contended that the materialman misapplied payments from the subcontractor by crediting them to invoices for equipment supplied to other projects. The trial

⁴³ 309 F.2d 22 (8th Cir. 1962), cert. denied, 372 U.S. 936, 83 S.Ct. 883, 9 L.Ed.2d 767 (1963).

⁴⁴ 646 F.2d 1037 (5th Cir. 1981).

⁴⁵ Id. at 1042; accord Dakota Electric, 309 F.2d at 29-30.

court determined that the aggregate amount of the payments from the general contractor to the subcontractor exceeded the aggregate amount of the payments from the subcontractor to the materialman. It concluded, therefore, that the general contractor's payments to the subcontractor had been the source of a substantial part of the subcontractor's payments⁴⁶ to the materialman and that, accordingly, the materialman had been obligated to apply such payments to the subcontractor's account for the bonded projects. As proper application would have greatly reduced that account, the trial court held that the general contractor and the surety had established an affirmative defense to almost all of the materialman's claim.⁴⁷

On appeal, the Fifth Circuit, while acknowledging that "[i]t is well settled that once it has been determined that a supplier has knowingly misapplied funds, the misapplied funds must be reallocated to the proper accounts,"⁴⁸ rejected the trial court's macro-analysis of the payments and reversed. The court held that before it could be determined whether the materialman had knowingly misapplied funds, it must be established that a misapplication had occurred in the first place.⁴⁹ To answer that question, it undertook an elaborate month-by-month analysis of the evidence which included appended charts and the expert testimony of an accountant. At most, it concluded, the evidence showed that it was possible that a portion of some of the payments had been misapplied. Placing the burden of proof squarely on the party raising the defense,⁵⁰ the court held that such a showing was insufficient:

As to the remaining funds, the most that can be said is that it is possible that they were misapplied. Such a naked possibility falls short of the preponderance of evidence required to be produced on behalf of Murray [the general contractor] and USF&G [the general contractor's surety] to support a finding of misapplication.⁵¹

The court's evaluation of the evidence suggests the problems and level of scrutiny that can be encountered in trying to trace payments to the bonded contract. Employing a micro-analysis, the court in Wiring reviewed for each month during which the materialman supplied equipment to the subcontractor: the deposits into the subcontractor's account of payments from the general contractor and from other sources, the payments made by the subcontractor to the materialman, the status of the subcontractor's accounts with the materialman for the bonded projects, and the materialman's application of the payments to invoices for the bonded projects and to those for other projects.

The court found that in some months, although the subcontractor made payments to the materialman, the subcontractor had received no payments from the general contractor. As to those months, the court held that there could have been no possibility of misapplication, because

⁴⁶ The trial court excluded most of the subcontractor's payments to the materialman made during the first month of one of the projects because the subcontractor had received only a very small first payment from the general contractor. Wiring, 646 F.2d at 1039 n. 1.

⁴⁷ Id.

⁴⁸ Id. at 1040.

⁴⁹ Id. at 1041-1042.

⁵⁰ Id. at 1042.

⁵¹ Id. at 1043.

no part of the payments made by the subcontractor to the materialman could have included funds from the general contractor. There were other months in which, although the subcontractor received payments from the general contractor, there were no outstanding invoices from the materialman for the bonded projects. The court held that as there were no outstanding invoices, the materialman was free to apply any payment, regardless of its source, to other accounts of the subcontractor.⁵²

That left months in which: (1) the subcontractor had received payments from the general contractor, (2) there were outstanding invoices for the bonded projects, and (3) the materialman applied the subcontractor's payments to accounts for other projects. The court focused on the fact that during those months, the subcontractor's receipts from the general contractor were but a fraction (10% to 11%) of its total receipts from all sources. Because of that fact, it was impossible to tell whether the subcontractor's payments to the materialman were from funds received by the subcontractor from the general contractor or from other sources. Therefore, the court concluded, the general contractor and its surety failed to sustain the burden of proving that there had been a misapplication, and the judgment requiring a reapplication was reversed.⁵³

The facts of Dakota Electric were less favorable to the surety on the tracing issue than those of Wiring. First, the aggregate amount of the payments from the general contractor to the subcontractor was less than one half of the total amount of the payments from the subcontractor to the materialman.⁵⁴ In Wiring, the subcontractor's receipts from the general contractor exceeded its payments to the materialmen, and that fact led the trial court to conclude that the general contractor's payments had been the source of the payments to the materialmen. Second, the Dakota Electric subcontractor's receipts from the general contractor constituted 3% of its total receipts from all sources,⁵⁵ while the Wiring subcontractor's receipts from its general contractor were 10% to 11% of its total receipts.⁵⁶ For both reasons, it was less likely in Dakota Electric than in Wiring that the subcontractor's payments to the materialman included funds paid to the subcontractor by the general contractor. As one would expect, the materialman in Dakota Electric argued that the payments it received were not comprised of funds originating with the general contractor.⁵⁷

Although the court acknowledged that the general contractor's payments to the subcontractor "cannot be traced through. . . [the subcontractor's] account to specific payments made from it"⁵⁸ to the materialman, it nevertheless found that the materialman had a duty to apply payments from the subcontractor to the subcontractor's account for the bonded project. Other than noting the aggregate amounts involved, the court made no effort to analyze the transactions between the general contractor and the subcontractor or the subcontractor and the materialman, nor did it suggest that any such examination was necessary. After reviewing four prior decisions⁵⁹

⁵² The question of requiring a reapplication to later arising debts is discussed in Section 3, infra.

⁵³ Wiring, 646 F.2d at 1045.

⁵⁴ Dakota Electric, 309 F.2d at 23.

⁵⁵ Id.

⁵⁶ Wiring, 646 F.2d at 1040.

⁵⁷ Dakota Electric, 309 F.2d at 25.

⁵⁸ Id. at 23.

⁵⁹ R.P. Farnsworth & Co. v. Electrical Supply Co., 112 F.2d 150 (5th Cir. 1940), reh'q denied, 113 F.2d 111 (1940), cert. denied, 311 U.S. 700, 61 S.Ct. 139, 85 L.Ed. 454 (1940).

in connection with the tracing issue, the court concluded:

It is to be admitted, as we have noted, that in these cases the flow of funds from the general contractor through the subcontractor to the supplier was more readily identifiable than is the situation here. But the decisions in those cases, and their significance for Miller Act purposes, are broader than the ability to identify funds as they pass from the prime to the sub to the supplier.⁶⁰

For the court in Dakota Electric, the key issue was not the identifiability of the payments to the contract funds. Instead, the court focused on the degree of control which the materialman had acquired over the subcontractor and the resulting access to the subcontractor's books and records and familiarity with its affairs. Despite the fact that the payments to the materialman could not be traced, the "closeness of the relationship"⁶¹ between the materialman and the subcontractor created an "overriding equity"⁶² requiring reapplication. The materialman knew or had reason to know that the subcontractor was receiving progress payments from the general contractor and knew "inferentially at least, because of Dakota's [the materialman's] experience with government projects, of the existence of a surety obligation on the Bass [general contractor's] contract."⁶³ Those facts were enough. The court stated its ultimate finding of fact and conclusion of law as follows:

Under these circumstances we believe that Dakota '[the materialman], if it did not have actual knowledge, at least had reason to believe, taking the realities of the situation seriously into consideration, that, despite the activity in the Schroeder [subcontractor] bank account and, through the accidents of chronology, the consequent inability to trace a particular dollar from Bass [the general contractor] through Schroeder to Dakota, the receipt of funds by Dakota was made possible to the proportionate extent by the progress payments by Bass. This, we think, is enough to bring this case within the equitable doctrine expressed in Farnsworth and its companion cases."⁶⁴

As applied in Dakota Electric, the misapplication of funds defense did not require, as in

United States ex rel. Carroll v. Beck, 151 F.2d 964 (6th Cir. 1945).

United States ex rel. Crane Co. v. Johnson, Smathers & Rollins, 67 F.2d 121 (4th Cir. 1933).

Columbia Digger Co. v. Sparks, 227 F. 780 (9th Cir. 1915).

⁶⁰ Dakota Electric, 309 F.2d at 30.

⁶¹ Id.

⁶² Id. at 29.

⁶³ Id. at 30.

⁶⁴ Id.

Wiring, that the surety present proofs which eliminated the possibility that payments to the materialman might have included funds received by the subcontractor from sources other than the general contractor. Rather, in Dakota Electric, then circuit Judge Blackmun applied a macro-analysis under which the surety prevailed by showing only that there were payments from its principal, the general contractor, to the subcontractor which enhanced the subcontractor's ability to make payments to the materialman and that the materialman had reason to know that fact.

Courts which take a narrow view of the misapplication of funds defense account for the result in Dakota Electric by emphasizing that opinion's focus on the close interrelationship between the subcontractor and the materialman. In American Oil Co. v. Brown Paving Co.,⁶⁵ for example, the court denied the defense because the materialman's knowledge of the source of payments not been shown and observed that "[i]n the St. Paul Case, the creditor was found actually to have 'effective control' of the debtor and thus had to know the source of payments made by the debtor."⁶⁶ The materialman in Dakota Electric could have known no such thing. There, the court, itself, conceded that the payments could not be traced back through the subcontractor's commingled checking account to the payments made by the general contractor. The most that could be said is that the payments to the materialman might have included some funds paid by the general contractor. There does not appear to have been any way for even the subcontractor to have "known" in any specific way that its payments included funds from the general contractor. Control, no matter how complete, could not have given the materialman greater knowledge than the subcontractor itself had.

In Wiring, of course, a showing that payments to the materialman might have included funds paid by the general contractor was held insufficient as a matter of law. The control factor does not supply the missing proof needed to trace the payments back to the general contractor. Shifting the analysis to control and hence to the issue of the materialman's knowledge masks the fact that on the threshold issue of tracing, the court in Wiring applied a different and much higher standard.

The Wiring approach was explicitly adopted in Silver Hill Concrete Corp. v. Thomason Industries Corp.,⁶⁷ where a materialman sought to recover from a Miller Act general contractor and its surety the balance claimed to be due for materials supplied to the general contractor's subcontractor on a federal project. Following Wiring, the Court held that the surety and the general contractor failed to meet their burden of showing that a misapplication had occurred.⁶⁸ The materialman had been supplying the subcontractor on several other projects, and the court held that the proofs did not exclude the possibility that the payments to the subcontractor for other projects funded the subcontractor's payments to the materialman. This failure meant that only a possibility of a misapplication had been shown and that "[s]uch a naked possibility⁶⁹ was insufficient.

In Eureka Stone Quarry, Inc. v. Pennsylvania Nat'l Mutual Cas. Ins. Co.,⁷⁰ the court cited

⁶⁵ 298 F. Supp. 528 (D.S.C. 1969) (applying South Carolina law which was held to be "in conformity with" the Miller Act cases).

⁶⁶ Id. at 537.

⁶⁷ 556 F. Supp. 291 (D.D.C. 1982).

⁶⁸ Id. at 294.

⁶⁹ Id. (quoting Wiring, 646 F.2d at 1043).

⁷⁰ 1993 U.S. LEXIS 17031 (E.D. Pa. 1993).

to the Wiring decision, but adopted an approach more in line with Dakota Electric in ruling in favor of the surety on its cross-motion for summary judgment dismissing the payment bond suit of a materialman based upon the misapplication of funds defense. In Eureka, the plaintiff was a material supplier to a subcontractor of the bonded principal on a Miller Act project. The plaintiff claimed that it was owed a balance of \$14,372.65 from the subcontractor in connection with the bonded contract. The record disclosed, however, that the subcontractor had made a final \$15,000 payment to the plaintiff one day after the subcontractor received a \$28,706.82 payment from the principal on the bonded project, which payment had nonetheless been applied by plaintiff to the oldest outstanding debt of the subcontractor on another project. The plaintiff contended that it had applied this payment in accordance with the instructions of the subcontractor without knowledge of the source of the funds.

The Eureka court, in addressing the cross-motions for summary judgment, conducted a hearing on the narrow issue of whether the plaintiff had or should have had knowledge that the source of that \$15,000 payment it received from the subcontractor was the general contractor (principal), thereby obligating the plaintiff to apply those funds to the amount due it on the bonded project. Despite the denials of the plaintiff's credit manager, the Court inferred from the credit manager's testimony that he had sufficient personal contact with the subcontractor and sufficient knowledge of the subcontractor's outstanding invoices that he knew or should have known that the source of the \$15,000 payment was monies paid the day before to the subcontractor by the principal in connection with the bonded project. The Eureka court noted that it was "extremely advantageous" for the plaintiff to apply payments against the non-bonded debts, thus casting doubt upon the credibility of the credit manager's assertion as to his lack of knowledge. The court ruled, based upon the timing of the payments, that the source of the payment at issue had been the bonded project and that the plaintiff had misapplied that payment and thus granted the surety's motion for summary judgment on its misapplication of funds defense.

The illustration case would likewise clearly pass muster under Dakota Electric. The immediacy with which the principal's checks to the materialman followed deposits of payments from the obligees on Bonded Projects B and C suggests a very strong likelihood that the obligees' payments funded the checks to the materialman. The materialman had enough information, some of it independently verified, to be chargeable with knowledge of that probability. While it is a closer question under the Wiring analysis, because there were no substantial receipts from another source after a payment by an obligee and before issuance of a check to the materialman, one would expect that even the Wiring court would have upheld the surety's misapplication of funds defense. The facts developed in the illustration case, however, were quite favorable to the surety. Under the tracing test imposed by Wiring, a case with less favorable facts may not result in a reapplication for the benefit of the surety.

Once payments to the claimant can be traced to the bonded contract, there may be circumstances under which the surety will not be required to prove that the claimant knew the source of the payments. In United States ex rel. Clark-Fontana Paint Co., Inc. v. WIBCO. Inc.,⁷¹ a materialman sued a Miller Act prime contractor and its surety for the unpaid balance of invoices for paint supplied to the prime contractor for use on a federal project. The prime contractor owed substantial amounts for paint previously supplied, and the materialman was specifically informed of the protection of the payment bond for the federal project in order to obtain its agreement to

⁷¹ 396 F.Supp. 1253 (D.D.C. 1975), aff'd, 539 F.2d 243 (D.C. Cir. 1976).

provide paint for that project. The materialman also continued to supply paint to the prime contractor for other projects which were not bonded.

During the relevant period, the materialman received total payments of approximately \$85,000 from the prime contractor. The court found, without any discussion of the proofs, that \$66,000 of that amount "was attributable"⁷² to the federal project. That amount was more than twice the price of the paint supplied for that project. After institution of suit, the materialman sent to the prime contractor a letter which purported to allocate the payments to extinguish the pre-existing obligations and the invoices for bonded project would require the creditor to ignore the debtor's instructions. In the absence of such a direction, the court reasoned, "there is little logic" to the knowledge requirement.⁷³ In WIBCO, there was no direction from the debtor and the materialman's allocation was held ineffective. Thus, the court held that the misapplication of funds defense should apply even if the materialman did not know the source of payments:

In any case, when it ultimately emerges that the payments came from a source intended to exonerate the surety . . . , the equities favor the court allocating the payments to fulfill this implicit purpose, even if the creditor had no knowledge of it, where there has been no effective allocation and no detrimental reliance by the creditor. Indeed, this is precisely the rule recognized in Restatement I of Contracts, supra, §394, illustration 3 at 745.⁷⁴

Section 394 of the Restatement of Contracts,⁷⁵ cited in the quoted passage, imposes a duty upon the creditor - - regardless of his knowledge - - to apply a payment to a matured debt which the debtor is under a duty to a third person immediately to pay "[w]here neither the debtor nor the creditor seasonably exercises his power to apply a payment to one of several debts . . ." ⁷⁶ As a general matter under the Restatement, if the debtor does not owe a duty to a third person - - such as a surety - - to devote a payment to the discharge of a particular obligation, the debtor has the power to direct that the creditor apply a payment to any one of several debts, and the creditor must comply.⁷⁷ If the debtor fails to make such a direction, the creditor may apply the payment as he chooses.⁷⁸ In the context of a construction suretyship relationship between the debtor and a surety, it is said that in the absence of a direction from the debtor, the creditor/materialman may apply a payment to a debt unrelated to the bonded project even if the creditor knows that the source of that payment was a payment under the contract for the bonded project.⁷⁹ Such a result presumably presupposes that although the creditor knew the source of the payment, he did not know of either the existence of the surety or the debtor's duty to the surety to use contract funds

⁷² Id. at 1255.

⁷³ WIBCO, 396 F. Supp. at 1256.

⁷⁴ Id.

⁷⁵ Restatement of Contracts (1932) (hereafter cited as Restatement).

⁷⁶ Restatement §394(1).

⁷⁷ Id. §387(a).

⁷⁸ Id. §387(b).

⁷⁹ Id. §387(b) comment g, illustration 10.

to pay for labor or materials furnished to the bonded contract.⁸⁰ If, however, the creditor knows or has reason to know not only that a suretyship relationship exists, but also that the debtor is under a fiduciary or contractual duty to the surety with respect to the use of funds derived from the bonded contract, then the creditor may not apply the payment to other debts.⁸¹

Thus, the Restatement envisions a case where the creditor knows that there is a suretyship relationship between the debtor and a surety, but does not know that the debtor has a duty to exonerate the surety by using funds derived from the bonded contract to discharge debts incurred for that project. The Miller Act cases, however, do not draw so fine a distinction. Although they often cite the Restatement provisions and reach results generally consistent with its overall scheme, the cases generally do not address the question of the creditor's knowledge of the debtor's duty, and proceed on the implicit assumption that, as a practical matter, those engaged in the construction business understand that a bond principal has a duty to exonerate his surety and therefore to use contract funds to satisfy debts incurred for the bonded project.⁸²

Under section 387 (b) of the Restatement, when the debtor has made no direction as to the application of a payment and the creditor does not know or have reason to know of any duty owed by the debtor to a third person, the creditor may apply the payment to any debt of the debtor provided that he "manifests an intention" to do so within a reasonable time.⁸³ The creditor must manifest his intention by providing "seasonable notification" to the debtor.⁸⁴ Thus, if a bonded contractor sends a check, drawn on funds received from the bonded contract, to his materialman with no direction as to the invoice to which it should be applied and if the materialman then sends to the contractor a statement of account showing application of the proceeds of the check to invoices for materials supplied to a non-bonded project, the materialman will have effectively exercised his power of election under the Restatement.⁸⁵ If, however, that materialman did not send to the contractor a statement of account or other notification of the application but merely noted the credit on its books and records, he will not have effectively exercised his power of election.⁸⁶ In that case, under section 394, the provision cited by the court in WIBCO,⁸⁷ the payment must be applied to the invoices for materials furnished to the bonded project even if the materialman did not know the source of the payment.⁸⁸

That was the situation in WIBCO, for there was no direction from the contractor and, as the

⁸⁰ See Koehring Co. v. United States ex rel. Hoover Equip. Co., 303 F.2d 468 (19th Cir. 1962) (finding that although the materialman knew the source of a payment, it did not know that that source was a bonded contract).

⁸¹ Restatement §389(e) comment a, illustration 5; see also Restatement §388 (limiting the debtor's power to control the application of a payment when he is under a duty to a third person to discharge a particular debt).

⁸² See supra p. 17 and 18 and accompanying notes; but cf. United States ex rel. Hyland Elec. Supply Co. v. Franchi Bros. Constr. Corp., 378 F.2d 134 (2d Cir. 1967) (Kaufman, J., dissenting) (suggesting that under Restatement §388 when a general contractor has noticed that a materialman has applied a subcontractor's payments to accounts for non-bonded projects and continues to issue checks payable jointly to the subcontractor and the materialman, the materialman did not have reason to know that the subcontractor was under a duty to the general contractor to apply the checks to the account for the bonded project; but agreeing nevertheless that the general contractor's surety, which did not have notice of the misapplication, would be entitled to a reallocation.

⁸³ Restatement §387(b).

⁸⁴ Id. §391.

⁸⁵ If the materialman did not have the knowledge specified under Section 389(e) as to the contractor's duty to the surety, the application would be binding on the surety under the Restatement.

⁸⁶ Restatement §391 illustration 2.

⁸⁷ WIBCO, 396 F. Supp. at 1256.

⁸⁸ Restatement §394(1)(a).

court found, the materialman's letter informing the contractor of the application was not sent within a reasonable time after payment and was therefore ineffective. Limited to its facts, WIBCO can be read narrowly a no more than a case which follows the traditional Restatement rule in section 394. WIBCO's usefulness to sureties would likewise be limited, for then the surety would be relieved of proving the claimant's knowledge only where there was no direction and the claimant failed to render a statement of account or other notification of the application of payments.

The court's reasoning in WIBCO, however, suggests a broader reading. Although the court cited Restatement section 394, it went on to argue that although the knowledge requirement may be "sound"⁸⁹ when a creditor is to be placed under a duty to apply payments in contravention of the debtor's instruction, there is no reason for the requirement when there has been no direction by the debtor. That reasoning applies whether or not the creditor has given notice of the application.⁹⁰ WIBCO may therefore extend to any case where there was no direction from the debtor even if the materialman had provided effective notification. Even when payment was made from a commingled account, the surety would not be required to prove the claimant's knowledge once the payments were traced to the bonded contract, so long as there was no detrimental reliance by the materialman. Thus WIBCO could be of critical importance to the surety and should be borne in mind when analyzing questions of the propriety of a claimant's application of payments. It should be noted that WIBCO was decided by Judge Gesell, the same judge who decided Silver Hill Concrete Corp. v. Thomason Industries Corp.⁹¹ In Silver Hill, Judge Gesell followed the Wiring approach in analyzing the tracing question. For Judge Gesell, at least, the surety must satisfy the threshold tracing test applied in Wiring in order to benefit from any possible relaxation of the knowledge requirement under WIBCO.

3. Reapplication to Later Arising Debts.

In the illustration case, the principal received from the obligee for Bonded Project A two checks, in the total amount of \$160,000, drawn jointly to the principal and the materialman. When the principal endorsed and delivered the checks to the materialman, the outstanding invoices for materials supplied to Bonded Project A totaled \$120,000. The materialman applied only \$10,000 of the \$160,000 of the joint check proceeds to those invoices, thereby reducing the amount thereof to \$110,000. The \$150,000 balance was applied to earlier invoices for other projects. Thereafter, the principal ordered, and the materialman furnished, additional supplies for Bonded Project A. By the time the claim was submitted to the surety, the materialman's claim for supplies furnished to Bonded Project A was in the total amount of \$200,000. Assuming a knowing misapplication of the proceeds of the joint checks, the question becomes: Is the surety entitled to a reapplication of \$150,000 (\$10,000 having been properly applied to the invoices for Bonded Project A) so as to reduce the claim to \$50,000, or is the reapplication limited to \$110,000 (the amount of the invoices for Bonded Project A at time of payment the after the proper application of the \$10,000) so as to reduce the claim to only \$90,000. The cases suggest that in the absence of overreaching on the part of the materialman, likely the is outcome that reapplication will be required only to the extent of the balance of the principal's account for the bonded project as it existed at the time that

⁸⁹ WIBCO, 396 F. Supp. 1256.

⁹⁰ Under the Restatement the power of the debtor to direct the application "ceases as soon as the payment is made". If no direction was made by the debtor, "the presumption is made that he thereby assents to such application as the creditor desires to make." Restatement §387 comment g.

⁹¹ 556 F. Supp. 291 (D.D.C. 1982).

the disputed payment was received and applied.

In United states ex rel. Jinks Lumber Co. v. Federal Insurance Company,⁹² the Miller Act general contractor issued checks drawn jointly to its wallboard subcontractor and to the materialman who supplied the wallboard. Payment by joint check was arranged pursuant to an agreement among the parties which also required the materialman to furnish copies of its invoices and monthly statements of the Subcontractor's account to the general contractor. Three joint checks were issued by the general contractor and endorsed and delivered by the subcontractor to the materialman. As to each check, the materialman withheld an amount necessary to satisfy in full the amount then owing by the subcontractor for wallboard delivered to the bonded project and turned over the remainder to the subcontractor. When the materialman later brought suit under the payment bond for the amount then owing on the subcontractor's account for the bonded project, the surety contended, and the trial court held, that the materialman's claim was estopped. The trial court reasoned that the aggregate amount of the three joint checks exceeded the total amount charged for the materials supplied to the bonded project and that if the materialman had retained all of the proceeds of the joint checks, the account would not only have been paid in full, but would have been overpaid. On appeal, the Fifth Circuit reversed. It held that the materialman fully satisfied the account balance of the subcontractor for the bonded project at the time each check was delivered and that the billing procedures employed by the materialman to establish the account balances were in accordance with standard industry practice.⁹³

Although the Jinks Lumber case was analyzed in terms of estoppel, it was cited with approval in Wiring, which addressed the problem under the misapplication of funds doctrine. Several of the payments at issue in Wiring occurred during months when there were no unpaid invoices outstanding for materials provided to the bonded project. As to those months, the court held that even if it could be said that the subcontractor's payments to the materialmen were comprised of funds received from the general contractor, there was no possibility of a misapplication because no amounts were then owing on account of materials supplied to the bonded projects. In deciding that "GE [the materialman] was free to apply the money received from wiring [the subcontractor] at a time when nothing was due on the. . . [bonded] accounts in accord with Wiring's specific directions,"⁹⁴ the court gave its reasons as follows:

It would place an intolerable burden on both the supplier and the subcontractor to require the supplier to hold payments by the subcontractor 'in trust', refusing to apply them to any outstanding invoices until something became due and owing on the federal project.⁹⁵

The Fifth Circuit in Jinks Lumber distinguished its earlier decision in Graybar Electric Co. v. John A. Volpe Construction Co.⁹⁶ Graybar involved a similar agreement for the general

⁹² 483 F.2d 153 (5th Cir. 1973).

⁹³ Id. at 156; see also Marmet Corp. v. Becon Services Corp., 794 F. Supp. 428 (D.C. Cir. 1992)(court rejected surety's argument that plaintiff materialman had waived bond claim by failing to deduct entire outstanding balance from series of joint checks (and returning portions of proceeds of joint checks to principal), where failure to deduct entire balance was in compliance with retainage agreement between claimant and principal).

⁹⁴ Wiring, 646 F.2d at 1044.

⁹⁵ Id.

⁹⁶ 387 F.2d 55 (5th Cir. 1967).

contractor's payment of its subcontractor by checks drawn jointly by the general contractor to the subcontractor and materialman. As in Jinks, Lumber, the materialman in Graybar retained so much of the proceeds of the joint checks as was necessary to pay in full the subcontractor's account for tile bonded project at the time of delivery of the checks and turned over the remainder of the proceeds to the subcontractor. In inducing the general contractor to issue the checks, however, the materialman and the subcontractor had represented that the full amount of each joint check represented the value of the materialman's equipment which had been, or was in the process of being, delivered to the site and that the materialman's endorsement of the joint checks would constitute full payment for that material. If the materialman had retained the full proceeds of the joint checks and applied those proceeds against the cost of materials delivered later to the bonded project, there would have been no amount outstanding for such materials. Finding that the materialman had misrepresented to the general contractor and that the general contractor detrimentally relied upon the misrepresentation in issuing the joint checks, the Fifth Circuit upheld the trial court judgment that the materialman was estopped from asserting that the general contractor and its surety were liable for the unpaid balance of the subcontractor's account.⁹⁷

In the illustration case, there was no basis for asserting any misrepresentation by the materialman. Therefore, the materialman was free under the misapplication of funds doctrine to apply so much of the proceeds of the joint checks as exceeded the principal's account for bonded project A at the time of payment to earlier and other obligations. That result is contrary to the outcome under the New York Lien Law which subjects payments received by the materialman to a trust which prohibits application for non-trust purposes even if no invoices relating to the public project were unpaid at the time of payment.⁹⁸

CONCLUSION.

Construction trust fund statutes and the common law misapplication of funds doctrine serve equitable purposes. Both rest upon the intuitively accepted notion that funds originating from a particular project ought to be used to pay for the labor and material which went into that project. The payment bond surety can benefit from that underlying equity. Subcontractors and materialmen, as well as the contractor, have a duty to credit payments, known to have originated with a bonded project, to invoices rendered for services and materials furnished to that project. Thorough and properly designed investigation and discovery may uncover and develop facts demonstrating that a claimant has breached that duty, and the surety may therefore be entitled to a revision of the claimant's accounting which results in a substantial reduction of the claim.

In the illustration case, the materialman had a facially valid claim for \$425,000 for materials delivered to bonded projects for which the principal conceded that it had not made payment. Nonetheless, through a detailed tracing of project funds, the surety's loss was reduced under the New York Lien Law from \$425,000 to \$95,000. Under the misapplication of funds defense, reallocation would have been made only to the extent of the principal's account at the time of payment. The resulting reduction of the loss to \$135,000, though less, would still have been substantial. Thus, construction trust fund statutes and the misapplication of funds doctrine can be important tools in limiting a surety's payment bond exposure.

⁹⁷ Id. at 60.

⁹⁸ See supra p. 12-13.