Texas Trust Fund Act

By Jerry Negrete

The Texas Trust Fund Act governs how contractors, subcontractors, and, sometimes owners, can use funds they receive on construction projects in Texas. The Act was created to protect unpaid materialmen, laborers, contractors, and subcontractors and provide another route to encourage recovery. All Texas contractors should be aware of the provisions contained within the Act, because violations can subject contractors to individual criminal and civil liability.

Chapter 162 of the Texas Property Code contains the Texas Trust Fund Act. Generally speaking, the Act requires that "trust funds" received for one project must be used to pay for labor and material on that specific project.

"Trust funds" fall into two categories: (1) construction payments and (2) loan receipts. Construction payments are defined as payments made to a contractor or subcontractor under a construction contract. While this definition is relatively straightforward, note the payments only pertain to a contract for the improvement of real property, which does not include contracts, for example, for the drilling of an oil or gas well. Additionally, construction payments do not include a contractor's fee under a cost-plus agreement.

Loan receipts are those sums borrowed and received by a contractor, subcontractor, or owner for the improvement of specific real property that are secured in whole or in part by a lien on the property. This definition includes owners who borrow funds, thus subjecting owners to the Trust Fund Act requirements as well. Currently, when a project financier withholds retainage from the owner, those sums are not actually received by the owner and, therefore, do not become construction trust funds. This discrepancy may be clarified during the 85th Legislative Session to ensure statutory retainage becomes construction trust funds.

Those who must protect the trust funds are called "trustees." Any officer, director, or agent of a contractor, subcontractor, or owner who receives, or who has control or direction of trust funds, is a trustee of those funds for the benefit of unpaid trust fund beneficiaries. The definition of a trustee is purposefully broad, and can subject those who have control over the trust funds to individual liability. "Trust fund beneficiaries" include artisans, laborers, mechanics, contractors, or materialmen who labor or furnish labor or material for a construction project. In the residential construction context, the property owner is also a trust fund beneficiary.

Note that, even if a construction contract is protected by a payment bond, the Trust Fund Act still applies, and all trustees must comply with the statutory requirements.

In addition to protecting the trust funds, residential contractors performing work on a homestead are subject to an additional requirement: They must deposit all trust funds into a construction account and maintain a record detailing each deposit and disbursement from the account. The contractor must also track all its direct and indirect costs charged to the owner, retain all invoices and other supporting documentation relating to each disbursement, and keep a complete copy of its records for one year after final completion of the project.

As stated above, "trust funds" must be used to pay for labor and material on a specific project and cannot be used for other purposes. A trustee who "intentionally or knowingly, or with intent to defraud," uses or otherwise diverts trust funds without first paying all trust fund beneficiaries may be subject to liability under the Act for misapplying the trust funds. A violation of the statute can result in criminal penalties, ranging from a Class A misdemeanor to a third-degree felony. And, although the language of the statute does not appear enforceable in a civil lawsuit, some courts will allow violation of the Trust Fund Act as an independent or conjunctive cause of action along with a breach of contract cause of action. The civil penalty will vary, depending on the trust fund total allegedly misapplied. Note that, if a civil penalty is assessed, it may not be dischargeable in bankruptcy if the requisite intent for the relevant discharge exception is shown.

A violation of the Act is determined on a case-by-case basis. However, the statute contains three specific situations that represent a trustee's "intent to defraud" trust fund beneficiaries. First, an intent to defraud exists when a trustee retains, uses, disburses, or diverts trust funds to intentionally deprive the beneficiaries of the funds. This situation arises when there is proof a trustee purposefully diverted funds to ensure the beneficiary would not receive the trust funds. An intent to defraud also exists when a trustee performing work on a homestead retains, uses, disburses, or diverts trust funds and fails to establish or maintain the required construction account, or fails to establish or maintain the required account record. Residential contractors should always maintain the required account and record, as a failure to do so may provide the evidence necessary to expose the contractor to liability under the Act. Finally, an intent to defraud exists when a trustee provides false information contained in an all bills paid affidavit under chapter 53 of the Property Code, and diverts the trust funds received because of the false information. It should go without saying that all statements contained in an affidavit should be accurate and truthful.

The Trust Fund Act contains affirmative defenses available to a trustee accused of misapplying trust funds. If the trustee can show it used trust funds to pay for its actual expenses directly related to the construction project, it may be able to avoid liability. As a result, even if the contractor is not required to maintain an accounting under the Act, it is advisable to maintain a record of all payments made and received as proof that trust funds have not been misapplied. Additionally, if the trustee can show it has retained certain trust funds because of a reasonable belief the beneficiary is not entitled to such funds, it may be able to avoid liability. Finally, a trustee may avoid liability if it pays the trust beneficiaries within 30 days after receiving notice of a criminal complaint or other criminal investigation.

The Texas Trust Fund Act contains common sense regulations governing the use of construction funds. However, the penalties can be severe. For this reason, all Texas contractors should become familiar with their duties as trust fund trustees under Texas law.

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