SURETY TODAY PRESENTATION

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This is the seventh edition of the Surety Today. Our topic today is "Trust Funds" and Lou's going to lead us off with a discussion of the nature and formation of express trusts and then I will take over a little after that.

THE FUNDAMENTALS AND NATURE OF EXPRESS TRUSTS

Lou: I should add my first introduction to surety law was about 1978 when I met a cantankerous lawyer, Jerry Sunderland, who worked for a surety. I had terminated for default his principal on three projects for the State of Maryland. I got a rather rude awakening to the law of surety at that point, being a young AG and not knowing exactly what surety was other than the fact that I had the money and he wanted it. We will go through the trust, which will be a little boring in the beginning because it's going to be about trusts in general as opposed to the trust fund statutes, but I think we need to have a basis first before we get into the trust fund statute, such as what is a trust and how does it generally work.

Courts define trust where legal title to property is held by one or more persons under an equitable obligation to convey, apply or deal with such property for the benefit of others. There are three primary parties to the ordinary trust. There's the Settlor, the Trustee and the Beneficiaries. The Settlor is the person or entity that creates the trust. Generally, that's the party that provides the property to be held in trust. The Trustee is the party who is appointed or required by law to perform the trust, and the one in whom the property is vested under either express or implied agreement to exercise those powers for the benefit of others. The Settlor and the Trustee may be one and the same, and often are. The Beneficiary is the person for whom the benefit of the trust is held.

So, after the players, how do you form a trust? Basically, there is a shorthand to two types of trusts: generally either express or implied. Express trusts are created by the direct and willful act or conduct of the parties by some writing, deed or words, expressly evidencing the intent to create a trust. Trusts can also arise by statute such as the Construction Trust Fund Statute, which is in very many states at this point. Implied trusts generally arise by the operation of law and are generally recognized as constructive trusts or resulting trusts, and we'll deal with those a little later. Just remember there are basically two types of trusts, express or implied.

Trusts can be either executed or executory. An executory trust involves a circumstance where the trust is intended, but the transaction has not been completed and remains imperfect for some reason. It is a trust that has been fully and finally declared, but requires some other act or acts in order to perfect the trust and to carry out the intention of a Settlor. An executed trust is one fully and finally declared by the person who created it so that nothing further remains to be

done in order to make it effective. So, we're going to deal mostly with, at this point, the express trust, leaving the implied trust for later.

An express trust is created when parties affirmatively manifest an intention that certain property is to be held in trust for the benefit of a third party. Typically what you find today is where parents create a trust for their children, which is a good example. It's usually done in a Will, but it can also be done outside of a Will as well, but it's a writing that creates a specific trust for a specific beneficiary. You don't really need technical words. All that is necessary is that you show the intent that a legal estate is vested in one person to be held in some manner for the purpose of another. You don't have to get hung up on the word "trust" or "trustee" because that itself does not create the trust, but rather the intention of the party creating the trust. The part that most people get wrong is that the essential words are that the unequivocal showing that the intention that the legal estate was vested in one person. I give Black Acres to John Doe as trustee for the benefit of my children. That would be sufficient to create a trust using those words. Courts determine whether a trust is created by the contractor, by the document by ascertaining the words used by the contract or by the terms of the contract, however phrased. That's why it's important to look to see what intent was conveyed in the document itself. Unlike contracts, trusts, do not require consideration to be valid and enforceable. If you go back to contracts, you need offer, acceptance and consideration. That's not required under a trust because here, Settlor could create the trust without the Beneficiary even knowing about it, without any consideration flowing from the Settlor to the Beneficiary, or without the Settlor ever gaining the acceptance of the Beneficiary. However, just like contracts, the person seeking to establish the existence of a trust bears the burden of proving the creation of a trust.

What are some of the elements of a valid trust? You need a declaration; words either written or oral, but you need a declaration to manifest an intention of a Settlor to create a trust. You need a trust *res,* Latin meaning a "thing," "property;" you need something to give in this part of the trust. You need a Trustee with active duties, you need to designate the Beneficiaries, you need a trust purpose and in some cases, you need delivery of the trust property, because one of the parts the court may look at is if the property is never transferred to the trust, then the trust does not become effective. On the wills and estate side of the law, people sometimes create a trust in their wills, but they never convey Black Acres into a trust to make it become trust property. They create a trust fund for children, yet they never deposit money into the account. That would be an example. So, the real thing you're looking at is you need a Trustee, a Beneficiary and trust property. Some of the things you do need, just like in a contract, is the intent.

You need the intent to create a trust, and that's where the courts will look at the words, either oral or written as to what the intent of the Settlor was in creating the trust. With regard to property, anything of value will do. It can be real property, personal property, tangible or intangible, it can consist of any type of property. The only difference is sometimes, depending on the nature of the trust, there has to be a physical transfer of the property to the trustee in order to make that trust effective. Regardless of what we're talking about in the way or property, it has to be clearly identified or ascertainable in some fashion. Beneficiaries are in the same category. You can identify one person; you can identify a group of Beneficiaries. The real key is whether

or not that Beneficiary is identifiable in some fashion and also has the capacity to take and hold property. When you're dealing with trust funds for children who are Beneficiaries, the Trustee determines how to distribute the funds, and they are usually distributed to a minor through a guardian for the minor children. One part that we'll twist on a little later, which will be mentioned now, is that persons who have only an incidental benefit in some manner to the performance of the trust are not Beneficiaries to the trust and cannot force the trust unless they were specifically intended to be Beneficiaries. There will be a couple of twists on that later on with regard to the Construction Trust Fund Statute. Generally, someone who is not the named Beneficiary cannot enforce the trust.

On the Trustee, the same thing. Anyone of legal age can be a Trustee, it could be a person or a corporation. They have to hold the property for others and they are duty bound under fiduciary duties, which I'm sure most everyone can understand, and the only odd part about a Trustee is that they don't have to accept to be the Trustee, they can refuse in the beginning or they can also refuse later on and there will be a substitute appointed. Even if there is no Trustee identified in the trust, the court will appoint one later. The court will not allow the trust to die merely because someone forgot to identify a Trustee.

WHERE CAN THE SURETY FIND TRUST FUND PROVISIONS

(1) General Indemnity Agreement

Mike: The question now is where do you find trust agreements? Where does the surety look for these kinds of agreements? Obviously, the General Agreement of Indemnity is one place and typically, there are trust fund provisions in most indemnity agreements, but they vary from surety to surety so you have to take a look at those agreements, look at the terms and compare them to what is required in the particular location where you are seeking to enforce the trust to see whether or not you have a valid trust provision. For the most part, courts have upheld and enforced the trust provisions in indemnity agreements in a variety of circumstances and a variety of terms but there are cases out there, and we will talk about some of those at the end, where they have not upheld the trust fund provision for various reasons. I have a paper that I wrote back in 2009 that I will send around to everybody after the call that goes into a lot more detail on all these issues relating to trusts, so that is something you can look forward to. It's a pretty long paper. I think there are like 300 footnotes that I wrote for the Surety Claims Institute, so I tried to do a good job there.

(2) Underlying Contracts

Typically, you will find trust fund provisions in the GAI. If you don't have one there or you have some difficulty in enforcing that provision, the next place to look is in the underlying contract. Sometimes you will find trust fund provisions in the construction contract itself. Let's say the Surety bonded a Subcontractor that went into default and was terminated, the Surety completed the contract and paid Subs and Suppliers - you can look at the contract between the GC and the Owner for trust provisions or the contract between the GC and the bonded Principal,

or the Principal and any Subcontractors or Suppliers. There might be trust fund provisions in any or all of these underlying contracts that the surety may be able to take advantage of either through the doctrine of equitable subrogation, where you would stand in the shoes of a satisfied claimant under their contract, or you can assert the provisions of trust funds through assignments, if you paid a claim and obtained an assignment, you could be able to assert the rights in the underlying contract there. In some jurisdictions, not in Maryland, when the bond incorporates an underlying contract by reference the terms of the underlying contract is treated as being part of the bond, you can get into the trust provisions that way. So, that's the second general area to look at.

(3) <u>Trust Fund Statutes</u>

The third area to look at is in particular states, whether there is a trust fund statute, and many jurisdictions have some form of construction trust fund statute legislation, but most do not. There was a survey that was done in 2004 of all 50 states, and I think the majority did not have any kind of construction trust statute, but there were many that did. So you just have to look to see if that's applicable. Also, you have to pay attention to the trust statutes because they vary widely by jurisdiction as well. Some are limited to private jobs, some are limited to residential jobs, some are criminal or penal in nature so that may not be a good recovery for the surety there. Some limit the recovery to a particular class that may not include the surety or some don't apply if a surety bond was issued. So, you have to look at the statutory trust fund language to see whether you can try to use the benefit of the trust fund in that situation. So, we will turn it over to Lou to talk about implied trusts.

IMPLIED TRUSTS

Lou: Implied trusts fall into two basic categories; constructive and resulting. The constructive trusts is not actually a trust, but rather a common-law remedy developed in equity or unjust enrichment. The elements of a constructive trusts are variously stated, but include obtaining property, retaining property through actual constructive fraud, a breach of fiduciary duty, duress, coercion, mistake or other wrongful conduct causing unjust enrichment to the wrongdoer. Basically, that's an equitable remedy that they are trying to fix what was taken wrongly. Again, the same thing though; a person who's trying to argue constructive trust has the burden of proof. Resulting trust is also an implied trust, but that's basically one where the express trust for some reason, has failed. Therefore, when the court sees that and they see the express trust has failed for some reason, then they will "fix it" and call it still a trust. That's where there may be a legal technical deficiency in the express trust where an express trust is not fully performed without exhausting the trust estate or where someone has bought property and they put it in the wrong person's name (they will fix that as well).

TRUST FUND PROVISIONS IN BANKRUPTCY

Mike: Frequently you find yourself, as sureties do, in bankruptcy. So, what becomes of these trust fund rights in bankruptcy? What kind of benefit can the sureties derive from having trust provisions in either the indemnity agreement or underlying contract or maybe even a

statutory trust? So, let's take a look at that issue in the bankruptcy context. As Lou discussed, the creation of a trust alters title or ownership of the trust property. Instead of the principal having total and complete ownership over the bonded contract funds, for example, upon creation of a trust, the principal becomes the trustee with only bare legal title, and the beneficiaries of the trust, the sureties, the subs, the suppliers, what have you, become the equitable owners of the trust.

When a bankruptcy case is filed, pursuant to the Bankruptcy Code, an estate is created and by operation of law, all of the debtor's property, wherever located and by whomever held, automatically becomes what is known as "property of the estate." Section 541 of the Bankruptcy Code defines property of the estate very broadly and it is construed by the courts very liberally to encompass as much property that the debtor has into the bankruptcy estate. Section 541(d) provides that property in which the debtor has only legal title becomes property of the estate only to the extent of the debtor's legal title, but not to the extent of any equitable interest that the debtor does not hold. So we see that the Bankruptcy Code has been drafted in a way to protect trust property, to recognize and preserve the special nature of trust funds by recognizing the distinction between legal title and equitable title. So in the bankruptcy courts, you will find that the courts will enforce and apply trust fund provisions.

The court will look to the federal bankruptcy law as to what constitutes property of the estate, but the court will then look to state law to determine the extent of the debtor's interest in the property to determine if a valid trust exists, and whether the principal, now the debtor in bankruptcy, holds only legal title. Whether a valid trust exists will be evaluated as of the date of the filing of the bankruptcy case, and the party asserting the existence of a trust will bear the burden of establishing its existence, so you will have that burden of proof if you're trying to enforce a trust provision.

Most courts, and in the paper I'll send you, you'll see, hold that trust fund provisions in the General Indemnity Agreement or construction contracts or trust fund statutes are valid and upheld and that the trust property is not property of the estate, so those trust fund provisions can be used by the surety to argue that such trust funds that are being held in the estate should be released, that the automatic stay which applies when a bankruptcy is filed, should not apply to those funds and that if an argument that a preference is being made or a preference payment has been made, an argument can be made in response to that that the funds paid were actually trust funds and therefore not subject to the preference provisions of the Bankruptcy Code. So, the existence of trust provisions can be very beneficial to sureties in the bankruptcy context.

TRUST FUND RIGHTS AGAINST THE IRS/LENDERS/CREDITORS

Lou: The times that I have dealt with similar issues are with banks, the IRS and/or creditors. With regard to the IRS and creditors, it is usually when they attach your bank account, and of course, either the general contractor or the subcontractor, and you haven't paid the person below you. With regard to the IRS, I have been able to convince them, at least in Maryland under the Trust Fund Statute, that those are not funds owed to the subcontractor if they are attaching the general contractor's bank account because the subcontractor owes suppliers and

sub-subcontractors. Regarding the bank account of the subcontractor, the same argument except I owe money to suppliers and what not. That seems it's been fairly successful with the IRS, particularly if I am representing the general contractor when I also send the IRS a copy of our payment bond, telling them if you take the money, I am going to have to pay under the payment bond, and all kinds of things will occur after that, so it's really not the subcontractor's money. The one interesting one is about banks; of course, factoring in accounts receivable. In Maryland there is a case where a bank did actually that; they swept the account and it wasn't decided on a motion, but they did say that the contractor had a cause of action against the bank for becoming an involuntary trustee; that is when someone helps the trustee breach their fiduciary duties in some fashion, that they themselves become an involuntary trustee and must return the trust property. Basically, of course, the bank screamed by saying "how can we, the poor bank, know that?" and the test was very simple. The person who helps the trustee breach the trust has to know or should have known the breach of trust or by statute or otherwise, he is subjected to the same liabilities because he did not do his due diligence. In Maryland, it can be quite easy; a bank factors accounts receivable to a contractor, he knows that unless he goes out and checks to make sure that contractor has paid his suppliers and subcontractors, or sub-subs, that bank would be under an involuntary trustee position where they could be liable for giving the funds bank.

Mike: Because Maryland has a Trust Fund Statute…

Lou: Maryland has a Trust Fund Statute, and the case that the Maryland court relied upon was an out-of-state case in Oklahoma that did have a trust fund statute, but without that, then the question becomes if you don't have a trust fund statute, what action should the bank take to find out whether or not the funds are still held in trust for someone else. The Trust Fund Statute makes it easy to put that obligation on the bank. But if it's in a contract that of which the bank has not knowledge, it gets a little harder to say that the bank should have known about it.

UNUSUAL CASE LAW

Mike: Like I said, generally speaking, trust fund provisions are upheld and enforced, but there are a handful of cases out there that haven't, and usually it's for specific reasons. So, let's look at a couple.

In re Construction Alternatives, 2 F.3d 670 (6th Cir. 1993) involves a dispute in the bankruptcy court between the surety and the IRS to bonded contract funds that were paid to the debtor. The court held that a trust was not created because the indemnity agreement trust provisions did not require the principal to keep any portion of the payments as separate trust funds in a separate account. The court believed that under Ohio law, unless such funds were segregated, no trust could exist.

In re Suprema Specialties, 370 Bankr. 517 (So. Dist. N.Y. 2007), the surety issued a bond to secure the principal's payments to suppliers, and the surety brought an adversary proceeding in the bankruptcy court asserting its rights to certain funds ahead of the principal's lenders. The court held that the indemnity agreement failed to identify a specific trust *res* because it permitted the principal to co-mingle funds, which prevented identification of the trust. Apparently the

court believed that was fatal to an express trust in and of itself and the court also found that there was no trust because there was no delivery of the trust *res*, as Lou was talking about earlier. The trust provision, in the court's view, was invalid because it sought to impose a trust on funds not yet made, not yet received or due.

Acuity, a Mu. Ins. Co. v. Planter's Bank, 362 F. Supp.2d 885 (W.D. Ken. 2005). In that case, the surety sued the bank that had seized the progress payments made to its principal from a bonded job and the court held that the trust cannot exist without a trust corpus and that a promise made in the indemnity agreement four years earlier could not impress a trust on funds received without some later action or evidence of intent. Under Kentucky law, merely identifying a future res is not enough. Property must have been in existence and identified at the time of creation of the trust.

So, you see how different jurisdictions and different laws and requirements within those jurisdictions can derail your trust fund argument, so you have got to be careful about what is the particular jurisdiction requiring, and then comparing that to your indemnity agreement or your underlying contract to determine whether you have sufficient basis to sustain a trust.

As I said, we will send out the paper to you and one word of caution there; that paper was written in 2009. There is a discussion in that paper about non-dischargeability in bankruptcy, which has been superseded by a Supreme Court decision in 2013, so that whole discussion in that paper regarding that topic is no longer valid, except for historical purposes, I guess.