CHAPTER 10

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HANDLING OTHER PEOPLES MONEY/CONSTRUCTION TRUST FUNDS

I. INTRODUCTION

The Texas Construction Trust Fund Act (herein referred to as the Trust Fund Statute) is an important statute for all persons involved in a construction project. The Trust Fund Statute is found in Chapter 162 of the Texas Property Code. Generally, the Trust Fund Statute is designed to ensure that when one handles other people’s money, the money gets to where it is supposed to go. However, the statute is somewhat unusual in that it contains both civil and criminal provisions.

The Trust Fund Statute is a powerful weapon to be used in cases seeking payment of construction funds. As such, lawyers need to be aware of the statute’s legal, ethical and criminal implications.

II. THE TEXAS TRUST FUND STATUTE

A. What are construction trust funds?

Ordinarily one thinks of “trust funds” as being related to express trusts created for a variety of purposes, such as estate planning. The Trust Fund Statute, however, provides that certain monies are automatically “trust funds” by operation of the statute. Specifically, the following constitute trust funds:

Construction payments are trust funds if the payments are made to a contractor or subcontractor or to an officer, director, or agent of a contractor or subcontractor, under a construction contract for the improvement of specific real property in this state. TEX. PROP. CODE § 162.001(a). This includes oral or written construction contracts. See Wentz v. Austin, 2005 Tex. App. LEXIS 10278 (Tex. App.—Fort Worth 2005, no writ) (Builder under oral contract with construction company prevailed on claim for breach of fiduciary duty).

Loan receipts are also trust funds if the funds are borrowed by a contractor, subcontractor, or owner (or by and officer, director, or agent of a contractor, subcontractor, or owner) for the purpose of improving specific real property in this state, and the loan is secured in whole or in part by a lien on the property. TEX. PROP. CODE § 162.001(b).

However, the fees paid to a contractor are not trust funds if the contractor and owner enter into a written contract for improvement of real property in this state before commencing construction and the contract provides for payment of the costs of construction plus a reasonable fee payable to the contractor. TEX. PROP. CODE § 162.001(c).

B. Who are the trustees and beneficiaries?

The Trust Fund Statute casts a wide net over all persons who handle other people’s money. Specifically, a contractor, subcontractor or owner (or any officer, director or agent thereof) who receives trust funds or who has control or direction of trust funds is a trustee. TEX. PROP. CODE § 162.002.

The beneficiaries of the trust funds paid or received in connection with an improvement are any “artisan, laborer, mechanic, contractor, subcontractor, or materialman who labors or who furnishes labor or material for the construction or repair of an improvement on specific real property in this state.” TEX. PROP. CODE § 162.003.

The Trust Fund Statute does not apply to banks, savings and loan, or other lenders, to the title company or closing agent, or to a corporate surety that issues a payment bond. TEX. PROP. CODE § 162.004. It has also been determined that the Trust Fund Statute does not apply to a factoring company. Park Environmental Equip. Ltd. v. Texas Capital Funding, Inc., 102 S.W.3d 243 (Tex. App. – Houston [14th Dist.] 2003, pet. denied) (Factoring company that purchased accounts receivable from a subcontractor not liable to unpaid supplier of the subcontractor).

Can the construction lawyer be a trustee under the Trust Fund Statute? A construction lawyer may be asked to escrow funds for a variety of reasons in connection with a construction project. The lawyer could be given trust funds by a project owner to distribute to a contractor client or lien claimants or could be given trust funds by a general contractor to distribute to subcontractors and suppliers. These funds may be trust funds as defined by the Trust Fund Statute, and, the lawyer could be the trustee.

Once the lawyer accepts these trust funds, he or she arguably has a fiduciary duty to the beneficiaries of those funds as defined by the statute – in addition to the fiduciary duty to the client. In this predicament, the lawyer must make sure that he or she fulfills his or her obligations under the Trust Fund Statute first and foremost. See TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT RULE 1.02(c) (“A lawyer shall not assist or counsel a client to engage in conduct that the lawyer knows is criminal or fraudulent). If these actions are inconsistent with the instructions of the client, the lawyer must withdraw from the representation of the client. TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT RULE 1.15(a) (“A lawyer shall decline to represent a client or, where representation has commenced, shall withdraw, except as stated in paragraph (c)1, from the

1 “When ordered to do so by a tribunal, a lawyer shall continue representation notwithstanding good cause for
representation of a client if: (1) the representation will result in violation of Rule 3.08, other applicable rules of professional conduct or other law; … ” However, withdrawal may not avoid the obligations under the Trust Fund Statute. As such, a lawyer in this situation will need to carefully consider the representation and acceptance of funds from a client related to a construction project.

C. Additional duties for residential homestead projects.

There are additional requirements on the construction of residential homestead projects. First of all, on projects that exceed $5,000, the contractor is required to deposit the trust funds into a construction account. TEX. PROP. CODE § 162.006(a). The construction account must be in a financial institution, and the statements from the financial institution must refer to the account as a “construction account.” TEX. PROP. CODE § 162.006(b). Only trust funds may be maintained in this account. TEX. PROP. CODE § 162.005(6).

A contractor is required to maintain an account record for the construction account that provides:

a. information relating to the source and amount of the funds in the account;

b. the date the funds were deposited;

c. the date and amount of each disbursement;

d. the person to whom the funds were disbursed; and,

e. the current balance of the account.

TEX. PROP. CODE § 162.007(a).

In addition, the contractor is required to maintain an account record for each construction project that specifies the direct costs and indirect costs charged to the owner. TEX. PROP. CODE § 162.007(b). Direct costs are “a cost included under a construction contract that is specific to the construction of the improvement that is the subject of the contract.” TEX. PROP. CODE § 162.005(3). Indirect costs are “a cost included under a construction contract that is not specific to the construction of the improvement that is the subject of the contract.” TEX. PROP. CODE § 162.005(4).

The contractor is also required retain all invoices and other supporting documentation received relating to funds that were disbursed from the construction account. TEX. PROP. CODE § 162.007(c). The contractor is further required to ensure that all deposits and disbursement documentation include the construction account number or information that provides a direct connection between the documentation and the account. TEX. PROP. CODE § 162.007(d). Finally, the contractor may not destroy information required to be maintained under this section before the first anniversary of the date the improvement that is the subject of the contract is completed. TEX. PROP. CODE § 162.007(e).

D. Liability for misapplication of trust funds.

(1) Civil liability for misapplication of trust funds.

A trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds. TEX. PROP. CODE § 162.031(a).

The Trust Fund Statute permits a civil cause of action against a trustee who misapplies trust funds. Lively v. Carpet Services, Inc. 904 S.W.2d 868, 871-873 (Tex. App.--Houston [1st Dist.] 1995, writ denied). This provision is significant in light of the fact, discussed above, that trustees include individual officers, directors and agents. As such, these individuals may incur personal liability regardless of the corporate form of the trustee.

For example, in Lively the sole owner and officer of a general contractor had control over trust funds and was held liable. Likewise, in C & G, Inc. v. Jones, two officers of a general contractor were sued for misapplication of trust funds. The officers argued that the company was a wholly owned subsidiary and the parent company directed what payments were made, and that they did not personally receive any funds. The Court, however, found that both were officers of the general contractor, had signatory authority over the checking account and wrote the checks out of the

3 A trustee acts with “intent to defraud” when the trustee:

a. retains, uses, disburses, or diverts trust funds with the intent to deprive the beneficiaries of the trust funds;

b. retains, uses, disburses, or diverts trust funds and fails to establish or maintain a construction account as required by Section 162.006 or fails to establish or maintain an account record for the construction account as required by Section 162.007; or

c. uses, disburses, or diverts trust funds that were paid to the trustee in reliance on an affidavit furnished by the trustee under Section 53.085 if the affidavit contains false information relating to the trustee’s payment of current or past due obligations. TEX. PROP. CODE §§ 162.005 (A)-(C).

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Terminating that representation. TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT RULE 1.15 (c).

2 Rule 3.08 is entitled “Lawyer as a Witness.”
account. As such, the court held both officers individually liable. *C & G, Inc. v. Jones*, 165 S.W.2d 450 (Tex. App.—Dallas 2005, no writ).

In addition, individual liability under the Trust Fund Statute may be non-dischargeable in bankruptcy under 11 U.S.C.A. § 523(a)(4). *See In re Nicholas*, 956 F.2d 110 (5th Cir. 1992) (Liability may be non-dischargeable if the Trust Fund trustee paid trust fund receipts to non-beneficiaries for items other than “actual expenses directly related” to the construction projects); *See In re Boyle*, 819 F.2d 583, 593 (5th Cir. 1987) (Liability dischargeable where there was no finding or evidence of fraud on the trustee’s part or any basis for any theory of fiduciary defalcation [embezzlement] other than the Trust Fund Statute itself).

(2) Criminal liability for misapplication of trust funds.

The Trust Fund Statute contains levels of criminal penalties. A trustee who misapplies trust funds amounting to $500 or more in violation of the Trust Fund Statute commits a Class A Misdemeanor. TEX. PROP. CODE § 162.032(a). A Class A Misdemeanor carries a potential fine up to $4,000 and up to one year in jail. TEX. PROP. CODE § 12.21. A trustee who misapplies trust funds amounting to $500 or more in violation of the Trust Fund Statute, with intent to defraud, commits a felony of the third degree. TEX. PROP. CODE § 162.032(b). A Third Degree Felony carries a potential fine up to $10,000 and jail confinement for no less than 2 years and no more than 10 years. TEX. PROP. CODE § 12.34.

In addition, with respect to violations of the statute relating to residential construction projects, a trustee who fails to establish or maintain a construction account in violation of the statute or fails to establish or maintain an account record for the construction account in violation of the statute commits a Class A Misdemeanor. TEX. PROP. CODE § 162.032(c).

(3) Defenses available to a claim of misapplication of trust funds.

The Trust Fund Statute provides an affirmative defense to a trustee of trust funds in both a criminal prosecution and a civil action. Specifically, a trustee who did not pay trust funds to the beneficiary is not liable under the statute if:

1. the trust funds “were used by the trustee to pay the trustee’s actual expenses directly related to the construction or repair of the improvement”;
2. the trust funds “have been retained by the trustee, after notice to the beneficiary who has made a request for payment, as a result of the trustee’s reasonable belief that the beneficiary is not entitled to such funds or such funds have been retained as authorized or required by Chapter 53” of the Property Code; or
3. the trustee paid the beneficiaries all trust funds which they are entitled to receive no later than 30 days following the written notice of a criminal complaint or other notice of a pending criminal investigation.”  

The Trust Fund Statute does not define what are “actual expenses directly related to” the construction project. As such, this determination is left to the courts- civil, criminal and bankruptcy.

In *McElroy*, the state was unable to convict a contractor because state did not prove that funds were not spent on labor, materials, and overhead directly related to the project. *McElroy v. State*, 667 S.W.2d 856 (Tex. App.—Dallas 1984), aff’d, 720 S.W.2d 490 (Tex. Crim. App. 1986). An Attorney General opinion is consistent with this holding and provides that actual expenses include overhead and other expenses necessary to obtain or complete the project provided that such expenses have in fact been incurred. Op. Atty. Gen. 1988, No. JM-945.

In *Wittig*, the affirmative defense did not apply where contractor admitted that funds were used to increase salaries and expand the business, rather than pay creditors. *Wittig Grass Sales, LLC v. Cimarolli* (*In re Cimarolli*), 2006 Bankr. LEXIS 1595 (S.D. Texas, 2006).

In *Morelli*, the state was unable to prove that payment to a consultant before contract execution, payment for an artist’s picture of the home, and payment of a municipal fine for an untimely inspection request were not legitimate expenses related to construction project. *Morelli v. State*, 9 S.W.3d 909 (Tex. App.—Austin 2000, pet. ref’d).

III. ISSUES ARISING UNDER THE TRUST FUND STATUTE

A. Making a demand for payment- what can you threaten?

A claim for payment under the Trust Fund Statute against a company and its individual officers, directors or agents raises unique issues because the statute is also a criminal statute. As such, the disciplinary rules that govern the conduct of attorneys also place limits on what threats can be made in a civil matter.

Disciplinary Rule 4.04(b) of the Texas Disciplinary Rules of Professional Conduct provides that a lawyer shall not present, participate in presenting or threaten to present criminal or disciplinary charges solely to gain advantage in a civil matter. Does a demand letter from an attorney for the payment monies owed that references the Trust Fund Statute violate Disciplinary Rule 4.04(b)?
One of the primary purposes of a written demand is to satisfy the requirements of Chapter 38 of the Texas Civil Practices and Remedies Code for the recovery of attorney’s fees. In order for a party to recover their attorney’s fees under that statute, a demand for payment must be made and payment must not have been made within 30 days of such presentment. TEX. CIV. PRAC. AND REM. CODE § 38.002.

There are no mandatory notice provisions, however, under the Trust Fund Statute. Also, under the Trust Fund Statute, the elements of a civil cause of action and a criminal action are the same (although there is a different burden of proof in a civil versus a criminal matter). As such, one may argue that a demand is really a threat of criminal charges to gain advantage in a civil matter as prohibited by Disciplinary Rule 4.04.

The answer as to whether a demand under the Trust Fund Statute violates Disciplinary Rule 4.04 is obviously fact dependent upon the language used in the demand letter. A lawyer must be aware of Rule 4.04 and should draft letters and take actions consistent with it. In addition, even if a lawyer violates Rule 4.04, the responding lawyer must also comply with Rule 4.04. Specifically, the responding lawyer may not threaten disciplinary charges for violation of Rule 4.04 because this may also violate Rule 4.04.

B. Defending a Trust Fund Statute claim- is your client a criminal?

In defending a civil claim under the Trust Fund Statute, a lawyer will focus on defeating the claim by either disproving one of the elements of the statute (the client is not a trustee or plaintiff is not a beneficiary, etc.) or by proving one of the affirmative defenses under the statute. However, counsel must remember that even though the claim is a civil claim, the Trust Fund Statute is also a criminal statute.

The lawyer prosecuting the claim will attempt to satisfy the elements of the criminal statute in order to recover money damages in the civil proceeding (a lawsuit or arbitration). Close attention must be paid by the civil defense lawyer to the evidence divulged by the client. If there was, in fact, a violation of the statute, the evidence gathered in the civil case could be used to prosecute the client in a criminal proceeding before, during or after the civil proceeding. As such, counsel must consider the impact of evidence provided including, but not limited to, verified interrogatory answers and testimony given by deposition or in a trial or arbitration.

For example, the most obvious area of concern is deposition testimony. During a deposition, the plaintiff’s lawyer will ask questions in an attempt to prove his client’s civil claim under the Trust Fund Statute. The answers to these questions may determine whether or not the client will be liable under the Trust Fund Statute in the lawsuit/arbitration. However, the civil defense lawyer must be cognizant of the client’s right not to incriminate himself/herself under the Fifth Amendment of the United States Constitution, and potentially advise the client not to answer questions on this basis.

For example, consider the following simple line of questions in a trust fund case involving a residential homestead:

Question: “Mr. Greedy is Greedy Remodelers a corporation?”
Answer: “No, its just a trade name I use.”

Question: “Did you maintain an account at a financial institution designated as a construction account?”
Answer: “Yes, I have a bank account.”

Question: “Do the periodic statements from this account specifically refer to the account as a “construction account?””
Answer: “Well it’s my operating account, but I deposited all the money from this job into it and used it to make payments to subcontractors.”

Question: “So the periodic statements from this account do not specifically refer to the account as a “construction account” correct?”
Answer: “Correct.”

Question: “Did you maintain a separate account record for the remodel of Mr. and Mrs. Homeowner’s house that specifies the direct and indirect costs charged to Mr. and Mrs. Homeowner?”
Answer: “Well, I get monthly bank statements…

Question: “I am not asking about bank statements, I am asking did you maintain a separate account record for the remodel of Mr. and Mrs. Homeowner’s house that specifies the direct and
indirect costs charged to Mr. and Mrs. Homeowner?”

Answer: “No.”

The above is a simple example of testimony in a civil case wherein the lawyer defending the contractor has allowed his or her client to admit to a criminal violation of the Trust Fund Statute under oath. This testimony admits to violations that are Class A Misdemeanors (fine up to $4,000 and up to one year in jail). The failure of the defense lawyer to advise his/her client of his right not to incriminate himself or herself could lead to a malpractice claim and could result in criminal prosecution of the client. This issue is magnified if the admissions relate to the misuse of trust funds, potential felonies.

Whether or not a client should refuse to answer the questions presented is outside the scope of this paper, and should be addressed by a criminal defense lawyer. However, the construction lawyer needs to be aware of this issue and consider utilizing a qualified criminal defense lawyer in the beginning of a case. The decision to refuse to testify may impact the civil case.

The Texas Rules of Civil Evidence permits comments and inferences to be drawn by the jury when a party asserts the privilege of self incrimination and refuses to testify at trial. TEX. RULE CIV. EVID. 513(C). At trial, the civil defense counsel will seek an instruction that an inference should not drawn from an assertion of privilege and the jury should not be allowed to hear the party assert his Fifth Amendment rights. The plaintiff’s lawyer will want to put the witness on the stand and force him or her to refuse to testify. Most lawyers believe the jury should be allowed to hear the witness take the fifth, provided there is other evidence supporting the inference to be drawn. Gregory N. Woods, Invocation of Fifth Amendment Privilege Against Self-Incrimination As Evidence in a Texas Civil Trial, October 1989, Tex. Bar J. 994, 996-998. See also, Wil-Roye Investment Co. II v. Washington Mutual Bank, FA.5

C. Pursuing a Trust Fund Statute claim- can you help the prosecutor?

What if you are pursuing a civil claim for breach of fiduciary duty under the Trust Fund Statute and your client wants you to assist him or her with the prosecution of a criminal complaint against the defendant? Again, under Disciplinary Rule 4.04 an attorney cannot threaten, present or participate in presenting criminal charges against a party solely to gain advantage in a civil matter. Texas Commission on Professional Ethics in Opinion 455 has addressed the following issue:

Should a lawyer, who represents a plaintiff in a civil suit alleging a cause of action against the defendants for damages for breach of contract, conversion and fraud, “assist” in prosecuting a criminal charge against such defendant?


Reviewing the predecessor rule to Disciplinary Rule 4.04, the Commission determined that the lawyer’s assistance with the criminal case during the pending civil matter involving the same parties and issues would not be proper. The Commission felt that lawyer’s “assistance” would be rendered suspect as an attempt to gain advantage in the civil matter. Id.

This opinion is instructive in the case where a lawyer is assisting his client in a civil case alleging Trust Fund Statute violations and the client wants the lawyer to “work with” the district attorney’s office in prosecuting the case.

As pointed out in Opinion 455, the district attorney’s office is perfectly capable of prosecuting the case without the lawyer’s assistance, leaving the presumption that the assistance is being provided to gain advantage in the civil matter. So, at least during the pendency of a civil matter, the civil lawyer should not assist the prosecutor in preparing a criminal case against the same parties.

D. Pursuing a Trust Fund Statute claim- can your client be liable for malicious prosecution?

A lawyer may need to be aware of the potential ramifications of a client that decides to prosecute a criminal complaint against a trustee (without the lawyer’s “assistance” if they are in a lawsuit already). In San Antonio Credit Union v. O’Connor, a contractor recovered damages against his homeowner client for malicious prosecution of a Trust Fund Statute claim. San Antonio Credit Union v. O’Connor, 115 S.W.3d 82 (Tex. App.—San Antonio 2003, pet. denied).

In that case, the homeowner terminated his contract with the contractor after receiving notices that

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4 A party must not assert the privilege in a way that renders the civil proceeding unfair. Texas Department of Public Safety Officers Ass’n v. Denton, 897 S.W.2d 757, 760 (Tex. 1995).
5 142 S.W.3d 393, 406-407 (Tex. App.—El Paso 2004, no pet.) (Concluding “that the rationale for allowing introduction of an agent’s admissions against the principal under Texas Rule of Evidence 801(d)(2)(D) also justifies admission of evidence showing that the agent/witness has exercised his Fifth Amendment privilege at least where the questions substantially relate to a party’s claim or defense.”)
the contractor had not paid some of its bills in connection with the project. The contractor alleged that he was unable to make the payments because the owner had not paid for agreed extras, there was a theft at the site, and, because the bank withheld retainage from the contractor despite an agreement with the homeowner not to do so. Id. at 88-91.

The homeowner gathered some of the documents pertaining to the payments by the bank, and the purported failure by the contractor to make payments to his subcontractors and suppliers, and attached them to a complaint filed with the San Antonio District Attorney’s office for violations of the Trust Fund Statute. The contractor was indicted, arrested and then released after posting bail. The district attorney dismissed the indictment, but on the dismissal sheet noted “case to be reindicted.” Id. at 90.

The contractor then sued the homeowners and their bank alleging several causes of action, including malicious prosecution. The trial court found that the homeowner maliciously prosecuted the contractor and awarded actual damages, exemplary damages and attorney’s fees. The court of appeals upheld the malicious prosecution claim, but remanded the case to the trial court for clarification on the damages. Id. at 108.

In order to prevail in a malicious prosecution claim, the plaintiff must establish that:

1. a criminal prosecution was commenced against the plaintiff;
2. the prosecution was initiated or procured by the defendant;
3. the prosecution terminated in favor of the plaintiff;
4. the plaintiff was innocent;
5. the defendant lacked probable cause to instigate the prosecution;
6. the defendant acted with malice in bringing the prosecution; and
7. the plaintiff suffered damages as a result of the prosecution.

Id. at 94; citing Richey v. Brookshire Grocery Co., 952 S.W.2d 15, 517 (Tex. 1997).

The homeowner only attacked elements four and five on appeal. The court of appeals upheld the jury’s findings as to lack of probable cause because the homeowner was aware that he had not paid the extras, that there was a theft of some of the contractor’s materials and that the bank had withheld retainage, i.e., meaning those were possible explanations for the failure to pay the subcontractors and suppliers, and not that the contractor had misapplied trust funds. The court of appeals also upheld the jury’s finding of innocence, commenting that such a finding was supported by the contractor’s declaration of innocence on the witness stand. Id. at 94-96.

E. Contract considerations.

Counsel should be aware of the Trust Fund Statute and its requirements when counseling a client with regard to contract issues. For example, often subcontracts (and some general contracts) contain a provision that allows the contractor to withhold payment on one project because of damages incurred or defective work on another project. For example, a general contractor may have the same subcontractor on two projects. The first project is fine and has no problems. However, the on the second project the subcontractor underbid the project, is having trouble paying its bills and manning the job, and has damaged some of work done by others. The general contractor may need to pay some supplier claims and pay to supplement the subcontractor’s work and pay to correct the damaged work. The general contractor exercises its right to apply some of the subcontract proceeds on the first project against the losses on the second project.

While the contractor may be within its contractual rights, it must consider the Trust Fund Statute prior to taking such actions. The general contractor must be careful not to violate the statute by using trust funds on one project to discharge debts on another project. If there are unpaid subcontractors or suppliers on the first project, there may be issues under the Trust Fund Statute.

Also, the subcontractor may have a claim against the general contractor for these actions because the subcontractor is a beneficiary under the statute. Once again, this is a criminal statute. Even though the parties may have agreed contractually that these actions could be taken, parties to a contract cannot contract around the applicability of a criminal statute. See Lewis v. Davis, 145 Tex. 468, 199 S.W.2d 146, 148-49 (Tex. 1947) (“A contract to do a thing which cannot be performed without a violation of the law is void.’ … But where the illegality does not appear on the face of the contract it will not be held void unless the facts showing its illegality are before the court.”)

IV. CONCLUSION

The Trust Fund Statute is a powerful weapon in claims involving payment disputes, and can bring about serious consequences. The construction lawyer needs to be aware of the statute’s legal, ethical and criminal implications. The construction lawyer must take care in advising clients with respect to the statute, in pursing and defending civil claims, and in assisting clients with criminal prosecutions.