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LENDER LIABILITY FOR DIVERSION OF TRUST ASSETS UNDER NEW YORK LIEN LAW ARTICLE 3-A

*Robert H. Bowmar**

INTRODUCTION

In the case of *Gerrity Company, Inc. v. Bonacquisti Construction Corp.*,¹ the New York State Supreme Court, Albany County (finding “no case directly on point”² with the situation there presented) held that once a bank has knowledge that an account holder is in the general contracting business, it has a duty to determine whether any Lien Law Article 3-A trust assets have been created. If so, it has the additional duty to ascertain whether any such assets are paid out at the time the bank exercises its setoff right against the account for a debt owed to the bank.³ Such a setoff, ac-

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1. 135 Misc. 2d 186, 515 N.Y.S.2d 188 (Sup. Ct. 1987), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988).

2. 135 Misc. 2d at 190, 515 N.Y.S.2d at 191 (Sup. Ct. 1987).

3. *Id.*

ording to the court, would constitute a diversion of trust assets, and the amount would be recoverable from the bank by the Article 3-A trust beneficiaries.⁴

Although the *Gerrity* duty was limited on appeal to situations where the bank has notice of an Article 3-A trust (the Appellate Division, Third Department, holding that knowledge of a depositor's construction business simply raises an issue of fact as to whether the bank had notice of the existence of such a trust),⁵ the risk of loss due to a finding of a diversion remains a significant one for lenders, like the bank in *Gerrity*, who deal with depositors in the construction industry. In what follows, a variety of transactions that have been or might be held to constitute diversions (including the one involved in *Gerrity*) are analyzed. A description of the Article 3-A trust provides a starting point for such an analysis.

I. THE ARTICLE 3-A TRUST

Article 3-A of New York's Lien Law provides the procedural framework for the creation and regulation of, as well as many of the substantive details for, a multi-layered system of trusts for the benefit of persons who supply labor, services, or materials for the improvement⁶ of real property.⁷ In the first layer, there is a trust called an owner trust. The trustee of such trust is the owner of the property improved (or to be improved).⁸ The beneficiaries of this trust are the

4. *Id.* at 193, 515 N.Y.S.2d at 192.

5. *Gerrity Co. v. Bonacquisti Constr. Corp.*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988). For an in-depth discussion of *Gerrity*, see *infra* text beginning at note 124.

6. Defined in N.Y. LIEN LAW § 2.4 (McKinney Supp. 1989). Note that while there is a distinction made in Articles 2 and 3 between a private improvement ("The term 'improvement of real property,' when used in this chapter means any improvement of real property not belonging to the state or a public corporation." N.Y. LIEN LAW § 2.8 (McKinney 1966)) and a public improvement ("The term 'public improvement,' when used in this chapter means an improvement of any real property belonging to the state or a public corporation." N.Y. LIEN LAW § 2.7 (McKinney 1966)), no such distinction exists in Article 3-A. The basis for the difference in treatment in Articles 2 and 3 is that in the case of a private improvement, the mechanics lien is on the real property itself (N.Y. LIEN LAW § 3 (McKinney Supp. 1989)), while in the case of a public improvement, the lien is against the funds of the state or public corporation to the extent of the amount due or to become due on the improvement contract (N.Y. LIEN LAW § 5 (McKinney Supp. 1989)). Herein, "improvement" or "improvement of real property" will be used to mean either a private or a public improvement, unless the context indicates otherwise.

7. Defined in N.Y. LIEN LAW § 2.2.

8. N.Y. LIEN LAW § 70.2 (McKinney 1966). For a definition of "owner," see N.Y. LIEN LAW § 2.3 (McKinney 1966). For instances of owner trusts, see *Northern Structures, Inc. v. Union Bank*, 57 A.D.2d 360, 394 N.Y.S.2d 964 (1977); *Fentron Architectural Metals Corp. v. Solow*, 101 Misc. 2d 393, 420 N.Y.S.2d 950 (Sup. Ct. 1979); *Schwadron v. Freund*, 69 Misc.

contractors,⁹ subcontractors,¹⁰ laborers,¹¹ and materialmen¹² who have claims "arising out of the improvement, for which the owner is obligated."¹³ The assets of an owner trust include:

the funds received by [the owner] and his rights of action for payment thereof (a) under a building loan contract; (b) under a building loan mortgage or a home improvement loan; (c) under a mortgage recorded subsequent to the commencement of the improvement and before the expiration of four months after completion of the improvement; (d) as consideration for a conveyance recorded subsequent to the commencement of the improvement and before the expiration of four months after the completion thereof; (e) as consideration for . . . an assignment of rents due or to become due under an existing or future lease or tenancy of the premises that are the subject of the improvement . . . if the assignment is executed subsequent to the commencement of the improvement and before the expiration of four months after the completion of the improvement . . . ; (f) as proceeds of any insurance payable because of the destruction of the improvement or its removal by fire or other casualty . . . ; [and] (g) under an executory contract for the sale of real property and the improvement thereof by the construction of a building thereon.¹⁴

2d 342, 329 N.Y.S.2d 945 (Sup. Ct. 1972); *Truax & Hovey, Ltd. v. Grosso (In re Grosso)*, 9 Bankr. 815 (N.D.N.Y. 1981).

9. Defined in N.Y. LIEN LAW § 2.9 (McKinney 1966) as "person[s] who enter[] into a contract with the owner of real property for the improvement thereof, or with the state or a public corporation for a public improvement."

10. Defined in N.Y. LIEN LAW § 2.10 (McKinney 1966) as "person[s] who enter[] into a contract with a contractor and/or with a subcontractor for an improvement of such real property or such public improvement or with a person who has contracted with or through such contractor for the performance of his contract or any part thereof."

11. Defined in N.Y. LIEN LAW § 2.11 (McKinney 1966) as "person[s] who perform[] labor or services upon such improvement."

12. Defined in N.Y. LIEN LAW § 2.12 (McKinney 1966) as "person[s] who furnish[] material or the use of machinery, tools, or equipment, or compressed gases for welding or cutting, or fuel or lubricants for the operation of machinery or motor vehicles, either to an owner, contractor or subcontractor, for, or in the prosecution of such improvement."

13. N.Y. LIEN LAW § 71.3(a) (McKinney 1966).

14. N.Y. LIEN LAW § 70.5(a)-(g) (McKinney Supp. 1989). For a definition of "building loan contract," see N.Y. LIEN LAW § 2.13 (McKinney 1966).

"Building loan mortgage" is defined in N.Y. LIEN LAW § 2.14 as "a mortgage made pursuant to a building loan contract . . . includ[ing] an agreement wherein and whereby a building loan mortgage is consolidated with existing mortgages so as to constitute one lien upon the mortgaged property."

A right of action for payment under an executory contract constitutes an asset of a "further trust" for the benefit of the executory contract vendee. N.Y. LIEN LAW § 71-a (McKinney Supp. 1989). See *Schwadron v. Freund*, 69 Misc. 2d 342, 329 N.Y.S.2d 945 (Sup. Ct. 1972). Additional assets of an owner trust are the funds received as proceeds of a loan advanced to

In successive trust layers come the trusts of which contractors and subcontractors are trustees—contractor trusts¹⁵ and subcontractor trusts.¹⁶ The beneficiaries of these trusts are “persons having claims for payment of amounts for which the trustee is authorized to use trust assets.”¹⁷ For example, a contractor may use trust assets for the “payment of claims of subcontractors . . . laborers and materialmen,”¹⁸ as well as for the “payment of taxes and unemployment insurance . . . due by reason of the employment out of which such claims arose.”¹⁹ The assets of a contractor trust are the funds

received by [the contractor] and his rights of action for payment thereof (a) under the contract for the improvement of real property, or home improvement or the public improvement; (b) under an assignment of funds due or earned or to become due or earned under the contract; [and] (c) as proceeds of any insurance payable because of destruction of the improvement of real property including a home improvement or public improvement or its removal by fire or other casualty²⁰

The assets of a subcontractor trust are similar to those of the contractor trust.²¹

Each type of trust begins “when any asset thereof comes into existence”²² (whether or not there is actually a trust beneficiary at

the trustee for the improvement, if a “Notice of Lending” has been filed (N.Y. LIEN LAW § 73.3(a), .5 (McKinney Supp. 1989)). For a discussion of “Notice of Lending,” see *infra* text beginning at note 67.

15. N.Y. LIEN LAW § 70.2 (McKinney 1966). For instances of contractor trusts, see *Ingalls Iron Works Co. v. Fehlhaber Corp.*, 327 F.Supp. 272 (S.D.N.Y. 1971); *Schreiber Hauling Co. v. Schwab Bros. Trucking*, 54 Misc. 2d 395, 283 N.Y.S.2d 69 (Sup. Ct. 1967); *Anthony Trinca & Assocs. v. Tilden Constr. Corp.*, 44 Misc. 2d 1094, 256 N.Y.S.2d 75 (Sup. Ct.), *aff'd sub nom.* *Continental Casualty Co. v. Ruth Factors*, 24 A.D.2d 703, 261 N.Y.S.2d 1004, *appeal denied*, 16 N.Y.2d 485, 211 N.E.2d 656, 264 N.Y.S.2d 1028 (1965).

16. N.Y. LIEN LAW § 70.2 (McKinney 1966). For instances of subcontractor trusts, see *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 236 N.E.2d 461, 289 N.Y.S.2d 175 (1968); *Tri-Boro Enterprises, Inc. v. Roger & McCay, Inc.*, 28 A.D.2d 860, 281 N.Y.S.2d 588 (1967); *Teman Bros. v. New York Plumbers' Specialties Co.*, 109 Misc. 2d 197, 444 N.Y.S.2d 337 (Sup. Ct. 1981).

17. N.Y. LIEN LAW § 71.4 (McKinney 1966). For a list of permissible uses of trust assets, see N.Y. LIEN LAW § 71.2(a)-(f) (McKinney Supp. 1989).

18. N.Y. LIEN LAW § 71.2(a) (McKinney Supp. 1989).

19. *Id.* at § 71.2(c).

20. *Id.* at s 70.6(a)-(c) (McKinney Supp. 1989). Funds received by a contractor under a valid “Notice of Lending” are also trust assets. N.Y. LIEN LAW § 73.5 (McKinney Supp. 1989). For a discussion of “Notice of Lending,” see *infra* text beginning at note 67.

21. See N.Y. LIEN LAW §§ 70.7(a)-(c), 73.5 (McKinney 1966 and Supp. 1989).

22. N.Y. LIEN LAW § 70.3 (McKinney 1966).

the time),²³ and continues until every trust claim "has been paid or discharged, or until all such assets have been applied for the purposes of the trust."²⁴ Persons may be trust beneficiaries whether or not they have filed (or even had a right to file) a notice of lien,²⁵ and a beneficiary may enforce the trust "in a representative action brought for the benefit of all beneficiaries of the trust."²⁶ The relief granted in any such action may include:

[r]elief to compel an interim or final accounting by the trustee; to identify and recover trust assets in the hands of any person . . . to set aside as a diversion any unauthorized payment, assignment or other transfer, whether voluntary or involuntary; to enjoin a diversion; [and] to recover damages for breach of trust or participation therein.²⁷

Payment of trust assets is handled by whichever party (owner or contractor) is trustee of the trust in question.²⁸ The trustee "is authorized to determine the order and manner of payment of any trust claims and to apply any trust asset to any purpose of the trust."²⁹ However, "[this] authority of the trustee . . . terminate[s] with respect to any trust assets as to which [a court] order for distribution is made."³⁰ Furthermore, once such a court order is made, a statutory hierarchy of preference among specific classes of trust claims goes into effect:

[I]n any distribution of trust assets pursuant to order or judgment in an action to enforce a trust, the following classes of trust claims shall have preference in the order named: (a) trust claims for taxes and for unemployment insurance and other contributions, due by reason of employments, and for amounts of taxes withheld or re-

23. *Id.*

24. *Id.* For a further discussion of trust purposes, see *infra* text beginning at note 38.

25. N.Y. LIEN LAW § 71.4 (McKinney 1966). For example, the State, having a claim for taxes accrued against a contractor in connection with the improvement, would qualify as a trust beneficiary of the contractor trust (see N.Y. LIEN LAW § 71.2(b), (c), .4 (McKinney Supp. 1989)), but could not, in any event, acquire a mechanic's lien on the property (see N.Y. LIEN LAW § s 3 (McKinney Supp. 1989)). See *e.g.*, Onondaga Commercial Dry Wall Corp. v. 150 Clinton Street, Inc., 25 N.Y.2d 106, 250 N.E.2d 211, 302 N.Y.S.2d 795 (1969); St. Paul Fire and Marine Ins. Co. v. State, 99 Misc. 2d 140, 415 N.Y.S.2d 949 (Ct. Cl. 1979).

26. N.Y. LIEN LAW § 77.1 (McKinney Supp. 1989). The trustee may also bring such an action. *Id.*

27. N.Y. LIEN LAW § 77.3(a)(i) (McKinney Supp. 1989). For a discussion of such illegal payments, see *infra* text accompanying notes 38-81.

28. N.Y. LIEN LAW § 74.1 (McKinney 1966).

29. *Id.*

30. N.Y. LIEN LAW § 74.2 (McKinney 1966).

quired to be withheld; (b) trust claims of laborers for daily or weekly wages; (c) trust claims for benefits and wage supplements; (d) claims for any amounts of wages of laborers for daily or weekly wages (other than claims for amounts of taxes deducted and withheld, constituting trust claims for such amounts) actually deducted from payments thereof, pursuant to law or agreement, for remittance to any person on behalf of the laborer or in satisfaction of his obligation. . . . Except as provided in this subdivision, trust claims entitled to share in any distribution of trust assets pursuant to order of the court shall share *pro rata*.³¹

Thus, although members of any class of trust claimant/beneficiary would be entitled to share *pro rata* in any court-ordered distribution of trust assets, a trust beneficiary may not complain if, before such a court-ordered distribution, the trustee distributes to another coordinate trust beneficiary more than his *pro rata* share, even if trust assets are thereby depleted.³² The trustee is not required to keep separate bank accounts for the separate trusts of which he may be trustee, "provided his books of account . . . clearly show the allocation to each trust of the funds deposited in his general or special bank accounts."³³ Moreover, if a trustee does deposit trust assets in a bank, "they shall be deposited in his name."³⁴ He must, however, keep separate books or records for each trust.³⁵ Failure of the trustee to keep the required books and records "shall be presumptive evidence that [he] has applied or consented to the application of trust funds . . . for purposes other than a purpose of the trust. . . ."³⁶—that is, that he is guilty of a diversion of trust assets.³⁷

31. N.Y. LIEN LAW § 77.8(a)-(d) (McKinney 1966).

32. See *Temam Bros., Inc. v. New York Plumbers' Specialties Co.*, 109 Misc. 2d 197, 201, 444 N.Y.S.2d 337, 341 (Sup. Ct. 1981).

33. N.Y. LIEN LAW § 75.1 (McKinney 1966).

34. *Id.*

35. N.Y. LIEN LAW § 75.2, .3 (McKinney 1966). Furthermore, trust beneficiaries are entitled to examine the trustee's books or to receive a verified statement relating thereto. N.Y. LIEN LAW § 76 (McKinney 1966).

36. N.Y. LIEN LAW §§ 75.4, 79-a.3 (McKinney 1966). See *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 236 N.E.2d 461, 289 N.Y.S.2d 175 (1968). Cf. *B.G. Equipment Co. v. American Ins. Co.*, 61 A.D.2d 247, 402 N.Y.S.2d 479, *aff'd*, 46 N.Y.2d 811, 386 N.E.2d 413 N.Y.S.2d 922 (1978); *Raisler Corp. v. Uris 55 Water St. Co.*, 91 Misc. 2d 217, 397 N.Y.S.2d 668 (Sup. Ct. 1977).

37. N.Y. LIEN LAW § 72.1 (McKinney 1966). See *infra* text accompanying note 38.

II. DIVERSION OF TRUST ASSETS

A. *What Constitutes a Diversion?*

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

Any transaction by which any trust asset is paid, transferred 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*, 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 of a purchaser in good faith for value and without notice that a transfer to him is a diversion of trust assets.³⁸

What is "a purpose of the trust?" In the case of an owner trust, trust assets "shall be held and applied for payment of the cost of improvement."³⁹ In the case of a contractor or subcontractor trust, trust assets must be held and applied for:

(a) payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen; (b) payment of the amount of taxes based on payrolls including such persons and withheld or required to be withheld and taxes based on the purchase price or value of materials or equipment required to be installed or furnished in connection with the performance of the improvement; (c) payment of taxes and unemployment insurance and other contributions due by reason of the employment out of which such claims

38. N.Y. LIEN LAW § 72.1 (McKinney 1966). Emphasis added.

39. N.Y. LIEN LAW § 71.1 (McKinney 1966). "Cost of improvement" is defined in N.Y. LIEN LAW § 2.5 (McKinney 1966) as expenditures incurred by the owner in paying the claims of a contractor, an architect, engineer or surveyor, a subcontractor, laborer and materialman, arising out of the improvement, and in paying the amount of taxes based on payrolls including such persons and withheld or required to be withheld and taxes based on the purchase price or value of materials or equipment required to be installed or furnished in connection with the performance of the improvement, payment of taxes and unemployment insurance and other contributions due by reason of the employment out of which any such claim arose, and payment of any benefits or wage supplements or the amounts necessary to provide such benefits or furnish such supplements

See *Fentron Architectural Metals Corp. v. Solow*, 101 Misc. 2d 393, 420 N.Y.S.2d 950 (Sup. Ct. 1979) (holding that ground rent is a cost of improvement, and that payment of ground rent by the owner to himself or his nominee pursuant to a split financing agreement is not a diversion).

arose; (d) payment of any benefits or wage supplements, or the amounts necessary to provide such benefits or furnish such supplements, to the extent that the trustee, as employer, is obligated to pay or provide such benefits or furnish such supplements by any agreement to which he is a party; and (e) payment of premiums on a surety bond or bonds filed and premiums on insurance accrued during the making of the improvement, including home improvement, or public improvement⁴⁰

Given the express, specific limitations on both the sources of trust assets⁴¹ and their applications,⁴² it might appear unlikely that either a trustee or his transferee could unwittingly become involved in a diversion.⁴³ Yet they have managed to do so in a variety of contexts. The errors that were made, along with the means available to avoid such errors, will be considered. If a diversion occurs, usually *both* the trustee and his transferee will be liable.⁴⁴ In the typical

40. N.Y. LIEN LAW § 71.2 (McKinney Supp. 1989).

41. See N.Y. LIEN LAW § 70.5 (owner trust), .6 (contractor trust), .7 (subcontractor trust) (McKinney 1966 and Supp. 1989).

42. See N.Y. LIEN LAW § 71.1, .3(a) (owner trust), 71.2, .3(b) (contractor or subcontractor trust) (McKinney 1966 and Supp. 1989).

43. Clearly, if a person *knowingly* transfers or receives trust assets for a non-trust purpose, that person is liable for a diversion. Even if a person is without actual knowledge of a diversion, he may be liable *therefor* where knowledge can be imputed to him. See, e.g., *Northwestern Structures, Inc. v. Union Bank*, 57 A.D.2d 360, 394 N.Y.S.2d 964, *amended*, 58 A.D.2d 1042, 396 N.Y.S.2d 1021 (1977); *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122 (Sup. Ct.), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1969); *Utica Sheet Metal Corp. v. J.E. Schecter Corp.*, 53 Misc. 2d 284, 278 N.Y.S.2d 345 (Sup. Ct. 1967). If the diversion occurs by the voluntary act or the consent of the trustee, such act or consent is a breach of trust (N.Y. LIEN LAW § 72.1 (McKinney 1966)) for which the trustee and any officer, director or agent thereof, may be guilty of larceny (N.Y. LIEN LAW § 79-a.1 (McKinney 1966)). See, e.g., *People v. Rallo*, 46 A.D.2d 518, 363 N.Y.S.2d 851 (1975), *aff'd*, 39 N.Y.2d 217, 347 N.E.2d 633, 383 N.Y.S.2d 271 (1976) (holding that evidence was sufficient to sustain an indictment against an attorney when that attorney had reason to know that corporate client Article 3-A trust assets he distributed to client officers were being used by them to satisfy personal obligations). See also N.Y. LIEN LAW § 77.3(a)(i) (McKinney 1966) (providing in pertinent part that relief available in an action to enforce a trust includes "damages for breach of trust or participation therein.").

44. See, e.g., *Merit Plumbing & Heating v. Eastern Nat'l Bank*, 221 N.Y.S.2d 143 (Sup. Ct. 1961). Liability for breach of trust may also extend to officers, etc., of corporate trustees or transferees. See *B.G. Equipment Co. v. American Ins. Co.*, 61 A.D.2d 247, 402 N.Y.S.2d 479, *aff'd*, 46 N.Y.2d 811, 386 N.E.2d 833, 413 N.Y.S.2d 922 (1978); *Scriven v. Maple Knoll Apts.*, 46 A.D.2d 210, 361 N.Y.S.2d 730 (1974); *Fleck v. Perla*, 40 A.D.2d 1069, 339 N.Y.S.2d 246 (1972); *Schwadron v. Freund*, 69 Misc. 2d 342, 329 N.Y.S.2d 945 (Sup. Ct. 1972); *Jasel Bldg. Prod. Corp. v. Polidoro (In re Polidoro)*, 12 Bankr. 867 (E.D.N.Y. 1981); *Truax & Hovey, Ltd. v. Grosso (In re Grosso)*, 9 Bankr. 815 (N.D.N.Y. 1981). Cf. *People v. Rallo*, 46 A.D.2d 518, 363 N.Y.S.2d 851 (1975), *aff'd*, 39 N.Y.2d 217, 347 N.E.2d 633, 383 N.Y.S.2d 271 (1976).

case, however, the trust action is brought against the transferee only, because the trustee has defaulted and is insolvent.⁴⁵ It is possible for the trustee alone to be liable.⁴⁶ Arguably, even an entity that is merely a *source* of trust assets may be liable for a diversion. Consider, for example, the sources of trust assets for a contractor trust.⁴⁷ If such a source knows or has reason to know that the funds to be advanced will be trust assets and that the contractor-trustee intends to apply them to non-trust purposes, but advances the funds anyway, the source should be treated as a participant in the diversion by the trustee.⁴⁸ This is not to say, however, that a source of trust assets has a duty to 'police' the trustee's activities once advances are made to the trustee.⁴⁹

Beyond the blatant case of a willful, knowing, fraudulent transfer of trust assets for the purpose of avoiding the trust fund provi-

45. See, e.g., *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 236 N.E.2d 461, 289 N.Y.S.2d 175 (1968) (subcontractor trustee default); *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122 (Sup. Ct. 1969), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1971) (contractor trustee default).

46. For example, the transferee of trust assets diverted by the trustee might qualify as a holder in due course or purchaser for value without notice. N.Y. LIEN LAW § 72.1 (McKinney 1966). See, e.g., *I-T-E Imperial Corp.-Empire Div. v. Bankers Trust Co.*, 73 A.D.2d 861, 423 N.Y.S.2d 491, *aff'd*, 51 N.Y.2d 811, 412 N.E.2d 1322, 433 N.Y.S.2d 96 (1980). Or, the transferee might qualify for the defense of subsection 1 of Lien Law section 73 (see *infra* text accompanying notes 67-71), but the trustee does not qualify for the defense of subsection 2 of that section.

47. N.Y. LIEN LAW § 70.6 (McKinney Supp. 1989). See *supra* text accompanying notes 18-20.

48. See, e.g., N.Y. LIEN LAW § 73.1, .5 (McKinney 1966). A transferee of trust assets may set up a defense to a diversion claim by filing a Notice of Lending and obtaining the covenant of the transferor-trustee, pursuant to § 73.1, that the trustee will apply transferee advances to trust purposes; however, since by § 73.5 the transferee's advances to the trustee are themselves trust assets, the transferee should be liable if he makes such advances with knowledge that they will be diverted by the trustee. *But cf.* *Home Fed. Sav. & Loan. Assn. v. Four Star Heights, Inc.*, 70 Misc. 2d 118, 333 N.Y.S.2d 334 (1972) (mechanic's lienor sought priority against building loan mortgagee under Lien Law Article 2, on basis that advances by latter to mortgageor were in violation of trust; court held that since the mortgagee was not a transferee of trust funds, Article 3-A was not applicable). Section 73 is discussed *infra* text beginning at note 67.

49. *Cf.* N.Y. LIEN LAW § 13(3), (5), (6) ("trust fund covenant" required in mortgages, conveyances, and assignments to obtain the benefit of the *lien* priority rules of Article 2; no obligation upon covenantee to see to the proper application of trust funds received by covenantor, mortgageor, grantor or assignor); N.Y. LIEN LAW § 73.1 (McKinney Supp. 1989) (transferee of trust assets, in order to get benefit of affirmative defense of Lien Law section 73.1, must show that he obtained covenant from transferor-trustee that the latter would receive and hold advances in trust; no express obligation to see to it that advances are so received and held). For a discussion of the related "Notice of Lending," see *infra* text accompanying notes 67-73.

sions of the Lien Law,⁵⁰ diversions come in a variety of forms. For example, a creditor of the trustee might levy on trust assets,⁵¹ a lending bank might exercise its right of setoff against trust assets in the trustee's account,⁵² or a factor might take an assignment of trust assets from a trustee as security for advances made by the factor to the trustee.⁵³

Generally, the risk of diversion is present whenever an Article 3-A trustee, whether an owner, contractor or subcontractor, enters into a financing arrangement with an entity that is different from the trustee's primary source of funds for the improvement. Examples of such primary source would be the building loan mortgagee for the owner, the owner for the contractor, and the contractor for the subcontractor. The financing arrangement itself might or might not relate to the specific improvement. For example, a financing entity might take an assignment from a contractor of the latter's rights under his contract with the owner, as security for advances to be made by the assignee to the contractor for the improvement,⁵⁴ or the financing entity might simply provide the contractor with a general unsecured line of credit, unrelated to the improvement.⁵⁵ In either case, the entity might be a bank in which the contractor has an account, against which the bank, upon default, might exercise its right of setoff.⁵⁶

50. See, e.g., *General Crushed Stone Co. v. State*, 19 N.Y.2d 737, 225 N.E.2d 893, 279 N.Y.S.2d 190 (1967).

51. See, e.g., *St. Paul Fire and Marine Ins. Co. v. State*, 99 Misc. 2d 140, 415 N.Y.S.2d 949 (Ct. Cl. 1979). Cf. N.Y. LIEN LAW § 72.2 (McKinney 1966).

52. See, e.g., *I-T-E Imperial Corp.-Empire Division v. Bankers Trust Co.*, 73 A.D.2d 861, 423 N.Y.S.2d 491, *aff'd* 51 N.Y.2d 811, 412 N.E.2d 1322, 433 N.Y.S.2d 96 (1980); *Northern Structures, Inc. v. Union Bank*, 57 A.D.2d 360, 394 N.Y.S.2d 964, *amended*, 58 A.D.2d 1042, 396 N.Y.S.2d 1021 (1977); *Gerrity Co. v. Bonacquisti Constr. Corp.*, 135 Misc. 2d 186, 515 N.Y.S.2d 188 (Sup. Ct. 1987), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988); *Utica Sheet Metal Corp. v. J. E. Schechter Corp.*, 53 Misc. 2d 284, 278 N.Y.S.2d 345 (Sup. Ct. 1967). This form of diversion is considered *infra* at Part F.

53. See, e.g., *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 236 N.E.2d 461, 289 N.Y.S.2d 175 (1968); *Eljam Mason Supply, Inc. v. I.F. Assocs. Corp.*, 84 A.D.2d 720, 444 N.Y.S.2d 96 (1981). Cf. *Teman Bros., Inc. v. New York Plumbers' Specialties Co.*, 109 Misc. 2d 197, 444 N.Y.S.2d 337 (Sup. Ct. 1981); *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122 (Sup. Ct. 1969), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1971). This form of diversion is considered *infra* at Part E.

54. See, e.g., *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122, (Sup. Ct. 1969), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1971).

55. See, e.g., *Gerrity Co. v. Bonacquisti Constr. Corp.*, 135 Misc. 2d 186 515 N.Y.S.2d 188 (Sup. Ct. 1987), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988).

56. See, e.g., *Northern Structures, Inc. v. Union Bank*, 57 A.D.2d 360, 394 N.Y.S.2d 964, *amended*, 58 A.D.2d 1042, 396 N.Y.S.2d 1021 (1977).

How might a diversion occur when such financing entities are involved? In the example of the contractor assignment, every dollar of the owner-contractor contract received by the entity as assignee is an asset of the contractor trust.⁵⁷ The receipt thereof by the assignee is not for a purpose of the trust⁵⁸ and, therefore, there is a diversion by both the trustee and the assignee as transferee.⁵⁹ A beneficiary of the contractor trust could bring an action for damages or for the recovery of the trust assets.⁶⁰ The mere fact that the assignee had made advances to the contractor-trustee would not be a defense to the diversion, irrespective of the amount of such advances; additional information regarding both the application of such advances by the trustee and possible notice of the assignment on the part of the beneficiary complaining of the diversion would be material.⁶¹

In the example of the financing entity that provides the contractor with a line of credit, above, every dollar of the owner-contractor contract either received by the entity in repayment of its credit loans⁶² or comprising part of the contractor's account against which the entity exercises its right of setoff,⁶³ is an asset of the contractor trust.⁶⁴ There is a diversion in both the receipt and setoff situations, since in neither one are trust assets applied for a trust purpose. Any advances made by the financing entity are assumed not to have been made in relation to the improvement.⁶⁵ Therefore, even more so than in the first example above,⁶⁶ the mere fact of such advances, regard-

57. See N.Y. LIEN LAW § 70.5(a) (McKinney Supp. 1989).

58. See N.Y. LIEN LAW § 71.2, .4 (McKinney 1966 & Supp 1989). For further discussion, see *supra* text accompanying notes 40-44.

59. See N.Y. LIEN LAW § 72 (McKinney 1966). Possible defenses are considered *infra* at Part D.

60. N.Y. LIEN LAW §§ 77.1, .3 (McKinney 1966 & Supp. 1989).

61. Such information as the basis for an assignee defense is considered *infra* in text beginning at note 99. Note that any such advances by the assignee would themselves become trust assets in the hands of the trustee. N.Y. LIEN LAW § 70.6(b) (McKinney Supp. 1989); *cf.* N.Y. LIEN LAW § 73.5 (McKinney Supp. 1989). Advances by an assignee to a *subcontractor*-assignor would likewise become assets of a subcontractor trust. N.Y. LIEN LAW § 70.7(b) (McKinney 1966); *cf.* N.Y. LIEN LAW § 73.5 (McKinney Supp. 1989). Advances by an assignee to an *owner*-assignor, however, are not necessarily assets of an owner trust. N.Y. LIEN LAW §§ 70.5, 73.5 (McKinney Supp. 1989). See *Kingston Trust Co. v. Catskill Land Corp.*, 43 A.D.2d 995, 352 N.Y.S.2d 514 (1974).

62. *Cf. Travelers Indem. Co. v. Central Trust Co.*, 47 Misc. 2d 849, 263 N.Y.S.2d 261 (Sup. Ct. 1965).

63. See *Gerrity Co. v. Bonacquisti Constr. Corp.*, 135 Misc. 2d 186, 515 N.Y.S.2d 188 (Sup. Ct. 1987), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988).

64. N.Y. LIEN LAW § 70.6(a) (McKinney Supp. 1989).

65. See *supra* text accompanying note 55.

66. See *supra* text accompanying note 61.

less of the amount thereof, provides no defense to the diversion.

B. *Defenses to Diversion*

There are defenses available to the different types of financing entities. In the case of the contract assignee who makes advances to be used for the improvement,⁶⁷ Lien Law section 73 may provide him with an affirmative defense to a claim of diversion.⁶⁸ In any action against him to recover assets diverted from the trust or to recover damages for the diversion, the assignee would be entitled to show (i) that he was a transferee named in a "Notice of Lending" (NL) filed as provided in subsection 3 of section 73;⁶⁹ (ii) that the transfer to him, *i.e.*, the diversion, was made as security for or in consideration of or in repayment of advances made to or on behalf of the trustee in accordance with the NL; and (iii) that prior to making

67. N.Y. LIEN LAW § 73.3(b)(3) (McKinney Supp. 1989).

68. Section 73 may be available to *any transferee* to whom a transfer of trust assets is "made as security for or in consideration of or in repayment of advances made to or on behalf of the trustee in accordance with [a] notice of lending . . ." N.Y. LIEN LAW § 73.1 (McKinney Supp. 1989).

69. The NL may be filed with the county clerk by either the trustee or the person advancing the funds, and it must contain

(1) a statement of the name and address of the person making the advances, (2) a statement of the name and address of the person to whom or on whose behalf they are made, and whether he is owner, contractor or subcontractor, (3) in the case of advances relating to one specific project for the improvement of real property including a home improvement or one specific public improvement, a description, sufficient for identification, of the improvement and of the real property involved for which the advances are made . . . , (4) the date of any advance made on or before the date of filing for which the notice is intended to be effective, (5) in the case of a notice of lending relating to several or undetermined projects, the date the notice will terminate, which termination date shall not be more than two years after the date the notice is filed, and (6) the maximum balance of advances outstanding to be permitted by the lender pursuant to the notice.

N.Y. LIEN LAW § 73.3 (McKinney Supp. 1989).

A "Notice of Assignment," in the form required by, and filed pursuant to Lien Law § 15 (private improvement), may serve as a NL. N.Y. LIEN LAW § 73.3(d) (McKinney Supp. 1989). There is no like provision for an assignment filed pursuant to Lien Law § 16 (public improvement). *But cf.* National Sur. Corp. v. Fishkill Nat'l Bank, 61 Misc. 2d 579, 583, 306 N.Y.S.2d 122, 127, *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1969) (court implied § 16 assignment might not serve the purpose of a NL); Schreiber Hauling Co. v. Schwab Bros. Trucking, 54 Misc. 2d 395, 283 N.Y.S.2d 69 (Sup. Ct. 1967) (court held that an agreement by which a surety on the contractor's bond subordinated its interest to contractor's assignee was not a § 73 NL); Anthony Trinca & Assocs. v. Tilden Constr. Corp., 44 Misc. 2d 1094, 256 N.Y.S.2d 75 (Sup. Ct.), *aff'd sub nom.* Continental Casualty Co. v. Ruth Factors, 24 A.D.2d 703, 261 N.Y.S.2d 1004, *appeal denied*, 16 N.Y.2d 485, 211 N.E.2d 655, 56, 264 N.Y.S.2d 1027, 1028 (1965) (court implied section 16 filing may be a substitute for a § 73 filing). There is also no provision to the effect that a NL may serve as a § 15 Notice of Assignment.

such advances, he had procured from the trustee the latter's written agreement that he would receive the advances and the right to receive them as trust funds⁷⁰ and apply the same to trust claims only.⁷¹ Section 73 may also provide a defense for transferees other than assignees of contract rights⁷² or for trustees.⁷³

If such defense is established by the assignee, he is entitled to a credit for the amount of the advances with respect to which it is so established, up to the maximum amount specified in the NL.⁷⁴ Presumably, the credit would be applied against the amount of trust assets transferred to the assignee in the diversion.⁷⁵ This works easily enough as to trust funds actually 'paid' to the assignee. But what about the *right to payment*, another type of trust asset, transferred to him by the assignment? Consider, for example, a case in which the stated NL maximum amount is \$100,000, the total amount advanced by the assignee is \$80,000, and the amount of trust assets

70. The advances made to the trustee pursuant to the NL are trust assets. N.Y. LIEN LAW § 73.5 (McKinney Supp. 1989). Cf. *supra* note 61.

71. Prior to 1966, the transferee was required to show that his advances to the trustee "were actually applied [by the trustee] for a purpose of the trust." In 1966, § 73.1 was amended to its present form. Act effective Aug. 1, 1966, ch. 919, 1966 N.Y. Laws 2708. Presumably, the transferee has a defense if he shows that his advances were actually applied to trust purposes, even if he has not obtained the trust fund covenant from the trustee. A showing that advances were actually applied to trust purposes is still required of the *trustee* who claims the defense of § 73.2.

The covenant required by § 73.1 is essentially the same as that required by section 13(6) in Article 2, albeit the latter is required only in every assignment of moneys due or to become due under a contract for the improvement of real property. Cf. N.Y. LIEN LAW § 25.5 (McKinney 1966) (trust fund covenant for assignments under contracts for *public* improvements). The presence of the section 13(6) covenant is probably intended as a condition to the application of the priority rules of section 13(1-a), but the statute is not clear on the question. Cf. *Aquilino v. United States*, 10 N.Y.2d 271, 281, 176 N.E.2d 826, 832, 219 N.Y.S.2d 254, 262 (1961) (holding that "[the § 13(6) covenant's] only effect is to substitute the proceeds of the assignment for the moneys due or to become due from the owner as the trust fund to which suppliers of labor and material may look for payment.").

72. See *supra* note 67. Conversely, the defense of § 73 would not be available to an assignee to whom trust assets were assigned "as security for or in consideration of or in repayment of advances" *not* made for trust purposes. See N.Y. LIEN LAW § 73.1, .3 (McKinney Supp. 1989).

73. N.Y. LIEN LAW § 73.2 (McKinney 1966). See *supra* note 71.

74. N.Y. LIEN LAW § 73.1 (McKinney Supp. 1989). The maximum amount of advances is required to be stated in the NL. N.Y. LIEN LAW § 73.3(b)(6) (McKinney Supp. 1989). The credit is lost, however, if the assignee fails to comply, within 10 days, with a written demand by a trust beneficiary for a verified statement of the amount of advances actually made to the trustee pursuant to the NL. N.Y. LIEN LAW § 73.4 (McKinney 1966).

75. In the case where a *trustee* is able to establish a § 73 defense to a diversion, the statute expressly provides for a credit "against any personal liability [of the trustee] by reason of such transfer." N.Y. LIEN LAW § 73.2 (McKinney 1966).

already paid to the assignee is \$50,000. If there is a balance of \$40,000 on the assigned contract, the 'credit' of section 73.1 should permit the assignee to reach \$30,000 of that balance, ahead of trust beneficiaries.⁷⁶

The purpose and function of the NL is to provide notice of the financing arrangement. "Notice of lending permits creditors of the [trustee] . . . to learn that their debtor's finances are tightly extended and, specifically, that its accounts receivable are assigned. Under such circumstances further credit would be granted charily and greater promptness of payment required."⁷⁷ The filed NL cannot provide such notice to trust beneficiaries who have acquired their status *before* NL filing. Arguably, then, an assignee who had fully complied with section 73 would not be entitled to that section's defense against such pre-NL beneficiaries. Such a result would mean that the assignee would be entitled to a 'credit' for his advances as against later beneficiaries, but not as against existing beneficiaries. Since the beneficiaries as a class are to be treated on a parity basis, a distinction between pre-NL and post-NL beneficiaries might generate a 'circular priority system.'⁷⁸ It is likely, however, that no such

76. That is, the assignee is given a priority as to that balance, in order to repay him the total \$80,000 advanced by him for the purpose of the trust. In the case posited, the trust beneficiaries would be relegated to sharing pro rata the \$10,000 left still owing on the assigned contract. See N.Y. LIEN LAW § 77.8 (McKinney 1966).

77. *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 514, 236 N.E.2d 461, 464, 289 N.Y.S.2d 175, 180 (1968). The *Caristo* court further stated: "[P]ersons who furnish materials and services in reliance on the trust assets receivable by the trustee at a later stage of the improvement are entitled to notice that those assets have been anticipated for current expense. Notice of the borrowing is needed as credit information." *Id.* at 514, 236 N.E.2d at 464, 289 N.Y.S.2d at 180 (quoting *Law Revision Commission, Report to the 182d Legislature*, at 32 (1959) (report entitled *Act, Recommendation and Study Relating to the Trust Fund Provisions of the Lien Law*, New York State Legislative Doc. No. 65(F) at 32)).

78. That is, the pre-NL beneficiaries would have priority over the assignee, who would have priority over post-NL beneficiaries, who would be on a parity with the pre-NL beneficiaries. N.Y. LIEN LAW § 77.8 (McKinney 1966). Faced with similar circular systems, involving mechanic's liens, courts have taken different views. Compare, e.g., *Mercury Paint Corp. v. Seaboard Painting Corp.*, 112 Misc. 2d 529, 447 N.Y.S.2d 191 (Sup. Ct. 1981) (first mechanic's lien, federal tax lien, second mechanic's lien; tax lien held to subordinate to second as well as to first mechanic's lien, since by section 13(1) mechanic's liens are to be treated on parity basis) with *In re Elmwood Farms*, 30 Bankr. 282 (S.D.N.Y. 1983) (first mechanic's lien, judgment lien, second mechanic's lien; second mechanic's lien held not to relate back to get benefit of priority status of first mechanic's lien).

Drawing a distinction between pre-NL and post-NL beneficiaries would also create problems in connection with priority disputes involving two or more contract assignees, subject to Lien Law section 13(1-a), the application of which is conditioned upon an assignment's not having been set aside as a diversion of trust assets. See N.Y. LIEN LAW § 13(1-a), (6) (McKinney 1966).

distinction was intended by the Legislature; the NL will be effective or not, as against all beneficiaries.

A transferee of trust assets who does not qualify for the section 73 defense may nevertheless avoid liability for a diversion if he can show that he is a holder in due course of a negotiable instrument or a purchaser in good faith for value and without notice that a transfer to him is a diversion.⁷⁹ For example, a transferee might make (or have made) advances to a trustee that are not for the purposes of the trust. Section 73 would not be applicable.⁸⁰ If the transferee were without notice of the trust, however, he might be a bona fide purchaser for value of the trust assets. A transferee might even make advances for the purpose of the trust, knowing thereof, but not know that what he receives as consideration for such advances constitutes trust assets; even if he fails to comply with section 73 (assumed to be applicable) such transferee might qualify as a bona fide purchaser of such assets. A transferee might not even make any advances but simply permit withdrawals by a trustee from an account that includes trust funds; the transferee would have a defense if he were a holder in due course of the negotiable instrument that was deposited by the trustee as a trust asset.⁸¹

C. Assignments

In *Caristo Construction Corp. v. Diners Financial Corp.*,⁸² a subcontractor (Raymar) assigned all its accounts receivable under existing contracts to a factor (Diners), to secure a revolving credit. One of the assigned contracts was with the general contractor (Caristo) on a hospital construction project. Diners knew that the

79. N.Y. LIEN LAW § 72.1 (McKinney 1966). However, a lien creditor of the trustee who seeks to levy on the trust assets would not qualify for this defense. See N.Y. LIEN LAW § 72.2 (McKinney 1966); *St. Paul Fire and Marine Ins. Co. v. State*, 99 Misc. 2d 140, 415 N.Y.S.2d 949 (Ct. Cl. 1979). Cf. *Aquilino v. United States*, 10 N.Y.2d 271, 176 N.E.2d 826, 219 N.Y.S.2d 254 (1961) (contractor-trustee-taxpayer held to have insufficient property in funds due under owner contract to permit attachment of federal tax lien ahead of subcontractors as trust beneficiaries).

80. Advances must be made "in accordance with" the NL (N.Y. LIEN LAW § 73.1 (McKinney Supp. 1989)), which may be filed "[i]f funds are advanced . . . for the purposes of the trust" (N.Y. LIEN LAW § 73.3 (McKinney Supp. 1989)). See *Gerrity Co., v. Bonacquisti Constr. Corp.*, 135 Misc. 2d 186, 515 N.Y.S.2d 188 (Sup. Ct. 1987), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988). The NL must contain a description "of the improvement and of the real property involved for which the advances are made." N.Y. LIEN LAW § 73.3(b)(3) (McKinney Supp. 1989).

81. See *I-T-E Imperial Corp.-Empire Division v. Bankers Trust Co.*, 73 A.D.2d 861, 423 N.Y.S.2d 491, *aff'd*, 51 N.Y.2d 811, 412 N.E.2d 1322, 433 N.Y.S.2d 96 (1980).

82. 21 N.Y.2d 507, 236 N.E.2d 461, 289 N.Y.S.2d 175 (1968).

assigned accounts represented trust funds,⁸³ but failed to file a NL pursuant to section 73.⁸⁴ When Raymar defaulted, Caristo paid off Raymar's subcontractors and suppliers in compliance with Caristo's obligations under a payment bond. Caristo, as subrogee of the subs and suppliers,⁸⁵ then commenced a trust action against Diners, claiming that the transactions between Raymar and Diners constituted diversions of trust assets. The procedure followed by Raymar and Diners was as follows: When Raymar received a check in payment of its work done for Caristo,⁸⁶ it would indorse the check and deliver it to Diners, which then deposited it under a masking code number in Diners' bank account.⁸⁷ At approximately the same time that it received the checks from Raymar, Diners issued its own checks in equal amounts to Raymar. The Diners checks did not indicate that their source of payment might have been assets of a trust. The effect of the check exchange was that the outstanding balance on the revolving credit remained the same except for accretions of interest.

The court held that Diners was liable for diversion. First, its crediting of the Raymar checks to the revolving loan account was

83. Such knowledge precluded a defense that Diners was a bona fide purchaser of trust assets. N.Y. LIEN LAW § 72.1 (McKinney 1966). For further discussion, see *supra* text accompanying notes 79-81.

84. In *Eljam Mason Supply v. I.F. Assocs. Corp.*, 84 A.D.2d 720, 444 N.Y.S.2d 96 (1981), the trial court dismissed the trust beneficiary's complaint on the basis that there had been no proof that a factor had either actual or constructive notice that the funds received by the factor were trust funds, even though the factor had not filed a NL. The Appellate Division reversed, finding that the evidence was sufficient to charge the factor with knowledge. On imputed knowledge, see *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 585, 306 N.Y.S.2d 122 (Sup. Ct.), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1969). *Cf.* *Northern Structures v. Union Bank*, 57 A.D.2d 360, 394 N.Y.S.2d 964, *amended*, 58 A.D.2d 1042, 396 N.Y.S.2d 1021 (1977) (diversion by bank setoff).

85. On the subrogation rights of an Article 3-A trust surety, see (in addition to *Caristo*) *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122 (Sup. Ct.), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1969); *Schreiber Hauling Co. v. Schwab Bros. Trucking*, 54 Misc. 2d 395, 283 N.Y.S.2d 69 (Sup. Ct. 1967); *Travelers Indem. Co. v. Central Trust Co.*, 47 Misc. 2d 849, 263 N.Y.S.2d 261 (Sup. Ct. 1965); *Anthony Trinca & Assocs. v. Tilden Constr. Corp.*, 44 Misc. 2d 1094, 256 N.Y.S.2d 75 (Sup. Ct.), *aff'd sub nom.* *Continental Casualty Co. v. Ruth Factors*, 24 A.D.2d 703, 261 N.Y.S.2d 1004, *appeal denied*, 16 N.Y.2d 485 (1965); *St. Paul Fire and Marine Ins. Co. v. State*, 99 Misc. 2d 140, 415 N.Y.S.2d 949 (Ct. Cl. 1979).

86. Such check and the right to payment represented thereby were assets of the subcontractor trust, of which Raymar was trustee. See N.Y. LIEN LAW § 70.7(a) (McKinney 1966).

87. Aside from the being a diversion, this action by Raymar was in violation of its duties as trustee regarding books, records, and bank accounts. N.Y. LIEN LAW § 75.1, .2 (McKinney 1966). A presumption of diversion was thereby raised against Raymar. See N.Y. LIEN LAW §§ 75.4, 79-a.3 (McKinney 1966). For further discussion, see text accompanying notes 33-36.

not an application of trust assets for a trust purpose. What Diners claimed to have been mere exchanges of checks — its own for those transferred to it by Raymar — were actually “new advances after the repayment of old ones under the revolving credit.”⁸⁸ Second, Diners issued its own checks payable to Raymar without any indication that either the checks or their source of payment might be a trust asset. Such activity “psychologically encouraged and practically permitted the subcontractor [Raymar] to ignore or confuse more easily its trust responsibilities.”⁸⁹ The court found, therefore, that “[t]he *several acts* of the factor, *especially when taken in conjunction*, would suffice either to effect or to facilitate a diversion of trust funds. By either of the factor’s acts the salutary purposes of . . . the Lien Law were avoided or blunted.”⁹⁰

Would Diners have had a defense had it filed a section 73 NL and obtained the trust fund covenant from Raymar,⁹¹ irrespective of the fact that the advances made to Raymar (i.e., the proceeds of Diners’ own checks) might not have been applied by Raymar to trust purposes?⁹² The answer should be yes, if one focuses upon the first, but ignores the second, of the two bases the court finds for holding Diners liable for diversion.⁹³ A NL filing, coupled with a trustee covenant, would provide a complete defense to Diners as regards the initial diversion, the receipt of the Raymar checks; how Raymar applied Diners’ ‘advances’ should be immaterial.⁹⁴

If the NL had been filed but no covenant had been obtained

88. *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 513, 236 N.E.2d 461, 463, 289 N.Y.S.2d 175, 179 (1968). Diners had argued that it did not retain the payments by Raymar “but simply acted as a conduit for the checks Raymar had received, *just as if it were a collecting bank*. It contends that the procedure followed was intended only to secure its lien . . . under the rule of *Benedict v. Ratner* (268 U.S. 353) [abolished by U.C.C. § 9-205] . . .” *Id.* at 512 (emphasis added). Diners could then assert by way of defense that it was a holder in due course of the checks. See N.Y. LIEN LAW § 72.1 (McKinney 1966); see U.C.C. §§ 3-302, 4-208, 4-209 (1987); *I-T-E Imperial Corp.-Empire Div. v. Bankers Trust Co.*, 73 A.D.2d 861, 423 N.Y.S.2d 491, *aff’d*, 51 N.Y.2d 811, 412 N.E.2d 1322, 433 N.Y.S.2d 96 (1980). The court stated that such an argument was “not substantial” and did “not require discussion.” 21 N.Y.2d at 515, 236 N.E.2d at 465, 289 N.Y.S.2d at 181.

89. 21 N.Y.2d at 515, 236 N.E.2d at 465, 289 N.Y.S.2d at 180.

90. *Id.* at 513, 234 N.E.2d at 464, 289 N.Y.S.2d at 179 (emphasis added).

91. N.Y. LIEN LAW § 73.1 (McKinney Supp. 1989). For further discussion, see *supra* text accompanying notes 70-71.

92. There was “no such evidence” indicating the use to which Raymar had put the proceeds of the Diners’ checks. 21 N.Y.2d at 513, 236 N.E.2d at 464, 289 N.Y.S.2d at 179.

93. See *supra* text accompanying notes 88-89.

94. See N.Y. LIEN LAW § 73.1 (McKinney Supp. 1989). For a discussion, see *supra* note 71.

from Raymar, it is arguable that Diners should have a defense if Raymar had actually applied Diners' advances to trust purposes. First, section 73.1 in its original form required that the transferee show that his advances were actually applied to trust purposes; under the 1966 amendment the transferee need only show that he obtained the trustee's agreement to apply the advances to trust purposes.⁹⁵ Presumably, the transferee satisfies a higher standard if he shows that advances were actually applied to trust purposes.⁹⁶ Second, even without the covenant, the trustee is bound to apply the advances to trust purposes, since the advances made pursuant to the NL are new trust assets.⁹⁷

If Raymar had not applied the advances to trust purposes, Diners should have no defense where no NL had been filed and no trust covenant had been obtained. Diners did not file the NL, however, so the question is whether Diners might have had any defense to the 'first' diversion notwithstanding the failure to file. Generally, once it is established that there has been either a failure to file the NL or a defective filing thereof, the availability of a defense to a transferee may depend upon (1) whether or not the person complaining of the diversion had notice (apart from the NL) of the financing arrangement between the trustee and the transferee, and (2) whether or not the trustee actually applied the transferee's advances to trust purposes. Arguably, the presence *vel non* of the trust fund covenant should not affect the outcome otherwise derived after consideration of these two variables.⁹⁸

Regarding the first variable, notice on the part of the complainant, there are indications, both by the courts⁹⁹ and by the Legisla-

95. See *supra* note 71.

96. Ostensibly, this view is inconsistent with the likely construction of the trust fund covenants found in Lien Law Article 2, § 13(3), (5) and (6). See *supra* notes 49 and 71. Substitution of trust funds for liens on real property is effected with the mortgagor and grantor covenants of subsections 3 and 5, and similar substitution of trust funds for moneys due on contracts (not viewed as trust funds) is effected with the assignor covenant of subsection 6. The presence of the covenants is a condition to a mortgagee, grantee, or assignee obtaining the benefit of the § 13 priority rules in subsections (2), (5) and (1-a), respectively. There is no authority for the proposition that the absence of such a covenant may somehow be 'cured' by the mortgagor's, grantor's, or assignor's application of amounts received to trust purposes. The substitution effected by § 73.1 is different, however: one set of trust assets (those transferred by the trustee to the transferee) are displaced by a second set of trust assets (the transferee's advances to the trustee) as a source of satisfaction of trust beneficiary claims. This difference militates against the treatment by analogy to the Article 2 covenants of the § 73 covenant.

97. N.Y. LIEN LAW § 73.5 (McKinney Supp. 1989).

98. Cf. *supra* note 96 and accompanying text.

99. See *supra* note 69. Cf. *Merit Plumbing and Heating v. Eastern Nat'l Bank*, 221

ture,¹⁰⁰ that substitutes for the constructive notice provided by the NL filing will be permitted. Even the court in *Caristo* placed much emphasis upon the fact that the contractor-subrogee-plaintiff had no knowledge of the financing arrangement between Diners and Raymar.¹⁰¹

There are problems with a substituted notice theory. If *all* trust beneficiaries had such notice, there would be a diversion or not, depending upon other factors,¹⁰² but the outcome would affect all beneficiaries equally. But what if some but not all beneficiaries had such notice? Would there be a diversion only as to those without notice?¹⁰³ If the plaintiff in the trust action were an assignee or subrogee of trust beneficiaries, as in *Caristo*, one would have to consider the effect of plaintiff's notice *vel non* as well as that of the beneficiaries.¹⁰⁴

Regarding the second variable, above, what if, following a technical diversion by a trustee to a transferee who has not complied with section 73.1, the transferee's advances are nonetheless actually applied to trust purposes, either by the trustee after receipt thereof or by the transferee directly? The *Caristo* court remarked that "if the 'exchange' checks had . . . been used by Raymar to pay trust

N.Y.S.2d 143, 146-47 (1961) (the court, construing Lien Law § 73.1 before the 1966 amendment thereto (*see supra* note 71), held that where no NL is filed, there is a diversion irrespective of notice if it is not shown that advances were applied to trust purposes). *But cf.* *Travelers Indem. Co. v. Central Trust Co. of Rochester*, 47 Misc. 2d 849, 263 N.Y.S.2d 261 (Sup. Ct. 1965) (court held that plaintiff's knowledge of financing transactions equitably estopped him from objecting to them as diversions; however, it is unclear whether transactions were within the scope of § 73.)

100. Lien Law § 73.3(d) provides for the substitution of a "Notice of Assignment" for the NL. For a discussion, see *supra* note 69.

101. The court remarked:

The general contractor [*i.e.*, *Caristo*], because of these devices, could not learn that it faced a greater risk of liability on its payment bond. Had it so learned, it could have taken measures to see that the subcontractor's [*i.e.*, *Raymar's*] trust responsibilities were effectuated, even to following the disbursements out of the project checks the general contractor was giving to the subcontractor.

Caristo Constr. Corp. v. Diners Fin. Corp., 21 N.Y.2d 507, 514, 236 N.E.2d 461, 464-65, 289 N.Y.S.2d 175, 180 (1968).

102. These factors include whether or not the trustee applied advances to trust purposes. *See infra* text accompanying note 105.

103. On the view that there may be a diversion as to some, but not all, trust beneficiaries, the entire class of which is to be treated on a parity basis (*see* N.Y. LIEN LAW § 77.8 (McKinney 1966)), a circular priority system might be generated. *Cf. supra* note 78 and accompanying text.

104. *Cf.* *Travelers Indem. Co. v. Central Trust Co. of Rochester*, 47 Misc. 2d 849, 263 N.Y.S.2d 261 (Sup. Ct. 1965); *Merit Plumbing and Heating v. Eastern Nat'l Bank*, 221 N.Y.S.2d 143 (Sup. Ct. 1961).

claims and there had been *no loss to anyone*, there would have been no ultimate diversion or loss for which the factor [*i.e.*, Diners] would be liable."¹⁰⁵

Obviously, if there had been "no loss to anyone," there would have been no trust action. The question is, what if the proceeds of the Diners' checks had been used by Raymar to pay certain trust claims but not others? Would Caristo, as subrogee of those trust beneficiaries not paid by Raymar, still have a claim against Diners for diversion?

The *Caristo* court does not address these questions directly; arguably, however, it implies that Diners might still have a defense. First, the court stated that not only did Diners not file the NL, but Diners also "did not attempt to prove, at trial, that the advances were in fact used for trust purposes."¹⁰⁶ Second, the court distinguished from the present case a case relied upon by Diners,¹⁰⁷ in which the factor had filed his assignment in compliance with Lien Law section 16 but not with section 73.¹⁰⁸ This was deemed to be adequate notice to beneficiaries. Also, the factor in that case had made advances directly to trust beneficiaries, by checks payable to them and not to the trustee.¹⁰⁹

If an assignee like Diners can show, notwithstanding noncompliance with section 73.1, that adequate notice has been acquired by beneficiaries¹¹⁰ and that the advances made by him have actually been applied to trust purposes, he should have a defense to a claim of diversion.¹¹¹ If the diverted assets themselves are restored or re-

105. *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 513, 236 N.E.2d 461, 464, 289 N.Y.S.2d 175, 179 (1968) (emphasis added). There was "no such evidence as to the use to which the 'exchange' checks were put." *Id.*

106. 21 N.Y.2d at 514, 236 N.E.2d at 464, 289 N.Y.S.2d at 180. Is it not a proper inference therefrom that a defense may be present even without the NL filing if notice is provided otherwise and the assignee's advances are applied to trust purposes?

107. *Anthony Trinca & Assocs. v. Tilden Constr. Corp.*, 44 Misc. 2d 1094, 256 N.Y.S.2d 75 (Sup. Ct.), *aff'd sub nom.*, *Continental Casualty Co. v. Ruth Factors*, 24 A.D.2d 703, 261 N.Y.S.2d 1004, *appeal denied*, 16 N.Y.2d 485, 211 N.E.2d 656, 264 N.Y.S.2d 1028 (1965).

108. *See supra* note 69. *But cf.* *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122, *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (Sup. Ct. 1969) (court questioned the effectiveness of § 16 filing as a substitute for NL of § 73 where there was no proof as to application of assignee advances).

109. *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 514, 236 N.E.2d 461, 464, 289 N.Y.S.2d 175, 180 (1968).

110. *See supra* text accompanying notes 99-104.

111. The fact that advances are used to pay some but not all trust claims is not itself a basis for complaint. *See* N.Y. LIEN LAW § 74.1 (McKinney 1966) (trustee has discretion in

turned to the trustee *and* thereafter actually applied to trust purposes, it should be immaterial whether beneficiaries had notice of the transactions of transfer and restoration; the restoration should be a defense to the transferee in the original diversion.¹¹²

Caristo is not inconsistent with these views: not only was there no proof that the assignee's advances, even if considered as merely 'restored' trust assets, were applied by the trustee to trust purposes,¹¹³ but also the court refused to consider the advances as a restoration or return of originally diverted trust assets. Unlike the dissent,¹¹⁴ the majority in *Caristo* did not accept the factor's position that there had been a mere exchange of checks, with no real transfer of trust assets to the factor; instead, the majority held that there had been two separate transactions: (1) the receipt of the Raymar checks by Diners in payment of outstanding loans, and (2) the issuance of the Diners' checks to Raymar as new loans.¹¹⁵ On the other hand, the majority seemed to approve in distinguishing *Anthony Trinca & Associates v. Tilden Construction Corp.*,¹¹⁶ in which the court required proof of *both* adequate notice to beneficiaries and ultimate application of assignee advances to trust purposes.

The court in *Caristo* found that Diners was guilty of a diversion when it received the entrusted payments (*i.e.*, the Raymar checks) and applied them on its outstanding loans, and again when it gave its own checks to Raymar.¹¹⁷ Thus, there were two diversions, involving

manner and order of payment of trust claims).

112. *Cf.* *Raisler Corp. v. Uris 55 Water St. Co.*, 91 Misc. 2d 217, 222-23, 397 N.Y.S.2d 668, 673 (Sup. Ct. 1977); *Schwadron v. Freund*, 69 Misc. 2d 342, 345-47, 329 N.Y.S.2d 945, 951-53 (Sup. Ct. 1972); *Travelers Indem. Co. v. Central Trust Co. of Rochester*, 47 Misc. 2d 849, 852-53, 263 N.Y.S.2d 261, 265-66 (Sup. Ct. 1965). Distinguish the case where a lender makes advances to a trustee, who applies them to trust purposes and *thereafter* repays the lender from trust assets received from another source. Such a lender, with knowledge of the trust source of repayment, is liable for the diversion. *Aetna Casualty and Sur. Co. v. Lafayette Nat'l Bank*, 35 A.D.2d 137, 314 N.Y.S.2d 818 (1970), *aff'd*, 30 N.Y.2d 638, 282 N.E.2d 621, 331 N.Y.S.2d 668 (1972) (court applied pre-1959 trust law, which tied every diversion to the crime of larceny; *see Schwadron*, 69 Misc. 2d at 345-47, 329 N.Y.S.2d at 951-53 (Sup. Ct. 1972)).

113. *See supra* note 105 and accompanying text.

114. *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 516-18, 236 N.E.2d 461, 465-66, 289 N.Y.S.2d 175, 181-83 (1968) (Fuld, J., dissenting).

115. 21 N.Y.2d at 512-13, 236 N.E.2d at 464, 289 N.Y.S.2d at 179. *See supra* note 88 and accompanying text.

116. 44 Misc. 2d 1094, 256 N.Y.S.2d 75 (Sup. Ct.), *aff'd sub nom.* *Continental Casualty Co. v. Ruth Factors*, 24 A.D.2d 703, 261 N.Y.S.2d 1004, *appeal denied*, 16 N.Y.2d 485, 211 N.E.2d 656, 264 N.Y.S.2d 1028 (1965).

117. *Caristo Constr. Corp. v. Diners Fin. Corp.*, 21 N.Y.2d 507, 510, 236 N.E.2d 461, 462, 289 N.Y.S.2d 175, 177 (1968).

two different sets of trust assets. The first diversion was obviously as transferee: the receipt of the Raymar checks and the application of their proceeds to non-trust purposes, namely, the Diners' loans. Raymar itself was guilty of diversion in the transfer of these checks to Diners.¹¹⁸ The second diversion was *by Raymar* of the proceeds of the checks received from Diners.¹¹⁹ Such proceeds were *new* trust assets of the subcontractor (Raymar) trust. As to these assets, Diners was neither a trustee nor a transferee — it was the *source* thereof. Yet the court found Diners guilty of a diversion as to such funds. The theory was, apparently, that Diners' transfer of its own checks operated to 'facilitate' the ultimate actual diversion by Raymar.¹²⁰

Generalizing, might one say that any person who is a *source* of trust funds¹²¹ may be found guilty of diversion if, with knowledge of the trust, such person makes advances to the trustee, knowing or having reason to know, either that the trustee intends to divert such funds or that *the circumstances attending the transfer of advances would facilitate a diversion should the trustee decide upon one*, and the trustee does in fact divert such funds? On such a view, even a transferee who had filed an NL and otherwise complied with section 73.1 would be guilty of diversion if advances made by him¹²² were applied to non-trust purposes by the trustee.

D. *Setoffs and Withdrawals*

There is a second line of cases, in which a claim of diversion has been made against a bank,¹²³ based upon either the bank's exercising

118. See N.Y. LIEN LAW § 72.1 (McKinney 1966). Raymar, who defaulted, was not a party to the suit. In any event, it would not be entitled to the defense of § 73.2: not only was there no NL filed, but also there was no proof that Raymar had applied Diners' advances to trust purposes. See *supra* notes 71 and 92.

119. If, on the contrary, Raymar had used the proceeds of the checks from Diners to pay trust claims, albeit not necessarily the claims of the beneficiaries to whose rights Caristo was subrogated (see N.Y. LIEN LAW § 74.1 (McKinney 1966)), Diners should have a defense. See *supra* text accompanying at note 105.

120. See *supra* text accompanying notes 89-90. This theory is a variant of that applied to counter a bank's defense of holder in due course of a deposited item against which withdrawals have been permitted. See *infra* text accompanying notes 128-130.

121. See N.Y. LIEN LAW §§ 70.5, 73.5 (McKinney Supp. 1989) (owner trust); N.Y. LIEN LAW §§ 70.6, 73.5 (McKinney Supp. 1989) (contractor trust); N.Y. LIEN LAW §§ 70.7, 73.5 (McKinney 1966 and Supp. 1989) (subcontractor trust).

122. Such advances would be trust assets. N.Y. LIEN LAW § 73.5 (McKinney Supp. 1989). Cf. N.Y. LIEN LAW § 70.6(b), .7(b) (McKinney 1966 and Supp. 1989).

123. Of course, a bank might be a transferee or assignee that seeks the benefit of the section 73 defense against a claim of diversion, within the first line of cases discussed in rela-

its right of setoff against the account of an Article 3-A trustee or the bank's honoring checks drawn by the trustee on a trust account and applied to non-trust purposes. The most recent of the cases is *Gerrity Company v. Bonacquisti Construction Corp.*¹²⁴

In *Gerrity*, the general contractor (Bonacquisti) received three payments from the owner on a real property improvement contract. Bonacquisti deposited the payments in its corporate checking account with Norstar Bank (Norstar). Norstar subsequently set off against the account the amount of certain demand notes given by Bonacquisti to cover general operating line-of-credit loans made by Norstar. Gerrity, a materialman of Bonacquisti, claimed that the setoff constituted a diversion of the assets of the contractor trust, of which Bonacquisti was trustee. Section 73 was not available as a defense because the loans by Norstar to Bonacquisti were not advanced "for the purposes of the trust."¹²⁵

The Supreme Court analyzed the sequence of deposits and withdrawals relating to the account, following Bonacquisti's deposit of each of the three payments, up to and including the date of Norstar's setoff. Applying the rule of first in, first out¹²⁶ to the withdrawals by the trustee Bonacquisti, the court found that the first two deposits of trust funds had been fully expended before the setoff by Norstar.¹²⁷ There being no trust assets consisting of all or a portion of those two deposits, there could be no diversion thereof effected by the setoff itself.

There was, however, an additional basis upon which the bank might have been guilty of diversion as regards the first two deposits: by permitting withdrawals, by checks drawn by Bonacquisti while the account still contained trust assets, which were then applied to

tion to *Caristo*, above. See, e.g., *National Sur. Corp. v. Fishkill Nat'l Bank*, 61 Misc. 2d 579, 306 N.Y.S.2d 122 (Sup. Ct.), *aff'd*, 37 A.D.2d 537, 322 N.Y.S.2d 980 (1969). Cf. *Aetna Casualty and Sur. Co. v. Lafayette Nat'l Bank*, 35 A.D.2d 137, 314 N.Y.S.2d 818 (1970), *aff'd*, 30 N.Y.2d 638, 282 N.E.2d 621, 331 N.Y.S.2d 668 (1972); *Travelers Indem. Co. v. Central Trust Co. of Rochester*, 47 Misc. 2d 849, 263 N.Y.S.2d 261 (Sup. Ct. 1965).

124. 135 Misc. 2d 186, 515 N.Y.S.2d 188 (Sup. Ct.), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988). See *supra* text accompanying notes 1-5.

125. 135 Misc. 2d at 193. See N.Y. LIEN LAW § 73.3 (McKinney Supp. 1989).

126. See *I-T-E Imperial Corp.-Empire Division v. Bankers Trust Co.*, 73 A.D.2d 861, 423 N.Y.S.2d 491, *aff'd*, 51 N.Y.2d 811, 412 N.E.2d 1322, 433 N.Y.S.2d 96 (1980); *Utica Sheet Metal Corp. v. J. E. Schechter Corp.*, 53 Misc. 2d 284, 278 N.Y.S.2d 345 (Sup. Ct. 1967). Cf. U.C.C. § 4-208 (1987) (for the purpose of deciding the extent to which a bank has a security interest in an item, credits first given are first withdrawn).

127. *Gerrity Co. v. Bonacquisti Constr. Corp.*, 135 Misc. 2d 186, 191-92, 515 N.Y.S.2d 188, 191-92 (1987).

non-trust purposes. As to such withdrawals, however, Norstar qualified as a holder in due course,¹²⁸ "since there was nothing to indicate that [it] . . . had any notice that the withdrawals constituted a diversion of trust funds [*i.e.*, that applications thereof by Bonacquisti were for non-trust purposes]" ¹²⁹ Thus, Norstar was protected by section 72.1.¹³⁰

So far no court has imputed such notice to a bank on the basis merely that the bank had notice of the trust nature of the account from which the withdrawals were made. One court stated the limitation, as follows:

[A] bank in which trust funds are deposited is under no duty to exercise vigilance to protect the trust estate from possible misappropriation by the trustee . . . and is *not bound to inquire* whether the fiduciary is applying such funds for the purpose of the trust, *unless the bank has notice of a threatened misappropriation and with that notice aids in the misappropriation.*¹³¹

As to the third payment received by Bonacquisti and deposited in its account with Norstar, the Supreme Court found that it was included in the account balance at the time of the setoff. Finding no case directly on point,¹³² the Court fashioned a duty of inquiry for banks like Norstar:

Norstar had a duty to determine if there had been any trust funds deposited in the corporate account, and, if so, whether the trust funds had already been paid out so that any non-trust money still remaining . . . could then be set off This court holds that, once a bank has knowledge that a corporate account is in the general contracting business . . . then such duty arises . . . *where the lender itself is going to be the transferee* of possible trust funds. At the

128. *Id.* at 193. See UCC §§ 3-302 (1987) (requisites for holder in due course status), 4-208 (1987) (bank has security interest in a check to extent credit given therefor is withdrawn), 4-209 (1987) (bank has given value for purposes of holder in due course status to extent it has security interest).

129. 135 Misc. 2d at 193, 515 N.Y.S.2d at 192.

130. *Id.* See *supra* text accompanying notes 79-81.

131. *Aetna Casualty and Sur. Co. v. Lafayette Nat'l Bank*, 35 A.D.2d 137, 141, 314 N.Y.S.2d 818 (1970), *aff'd*, 30 N.Y.2d 638, 282 N.E.2d 621, 331 N.Y.S.2d 666 (1972) (emphasis added). See *I-T-E Imperial Corp.-Empire Division v. Bankers Trust Co.*, 73 A.D.2d 861, 423 N.Y.S.2d 491, *aff'd*, 51 N.Y.2d 811, 412 N.E.2d 1322, 433 N.Y.S.2d 96 (1980); *Gerrity Co. v. Bonacquisti Constr. Corp.*, 135 Misc. 2d 186, 193, 515 N.Y.S.2d 188 (Sup. Ct. 1987), *modified*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988); *Utica Sheet Metal Corp. v. J. E. Schechter Corp.*, 53 Misc. 2d 284, 287, 278 N.Y.S.2d 345 (Sup. Ct. 1967). *Cf. supra* notes 121-22 and accompanying text.

132. *Gerrity*, 135 Misc. 2d at 190, 515 N.Y.S.2d at 191.

time of the setoff by defendant Norstar, no investigation, tracing or determination was made by it.¹³³

The Court held that Norstar had diverted the entire third trust fund deposit by Bonacquisti.¹³⁴

On appeal, however, the Appellate Division, Third Department, modified the opinion of the Supreme Court as regards the third payment.¹³⁵ It held that the mere fact that Norstar was aware that Bonacquisti, a depositor on a regular, otherwise undesignated checking account, was engaged in the construction business, or even that Bonacquisti, as a general contractor, might from time to time have received payments constituting trust funds did not alone establish that Norstar's setoff was effected in bad faith so as to preclude its claiming protection as a holder in due course or good faith purchaser for value.¹³⁶

The Court stated that the bank was entitled to "indulge the presumption that the trustee is applying trust assets to a proper purpose."¹³⁷ However, the Court continued, this rule does not apply when the bank has knowledge that the personal account is comprised largely of trust assets and that the setoff would substantially deplete it.¹³⁸

There are two questionable aspects of the decision: First, although the Supreme Court had carefully distinguished the issue of bank liability in the case of trustee account withdrawals that are applied to non-trust purposes¹³⁹ from that in the case of bank setoff, applying a stricter standard in the latter than in the former,¹⁴⁰ the Appellate Division, with not even a reference to the distinction, simply applied the withdrawal standards to the setoff case.

Second, both courts assumed that notice *vel non*, on the part of the bank that exercises a right of setoff against a trust account, is

133. *Id.* (emphasis added).

134. *Id.* at 193-94, 515 N.Y.S.2d at 193.

135. *Gerrity Co. v. Bonacquisti Constr. Corp.*, 136 A.D.2d 59, 525 N.Y.S.2d 926 (1988). The Appellate Division left undisturbed the Supreme Court's analysis regarding the first two payments.

136. *Id.* at 63-64, 525 N.Y.S.2d at 929.

137. *Id.* at 64, 525 N.Y.S.2d 929. *Cf. In re Knox*, 64 N.Y.2d 434, 477 N.E.2d 448, 488 N.Y.S.2d 146 (1985).

138. 136 A.D.2d at 64-65, 525 N.Y.S.2d at 929-30; *see also Ben Soep Co. v. Highgate Hall*, 142 Misc. 2d 45, 535 N.Y.S.2d 1018 (Sup. Ct. 1988).

139. *See supra* text accompanying notes 128-31.

140. *See supra* text accompanying note 133.

material on the diversion issue. They are not alone in this view.¹⁴¹ Certainly, if the bank were a *purchaser*-transferee of the trust assets, notice on its part would be material; section 72.1 sets up a diversion defense for a bona fide purchaser for value without notice.¹⁴² A bank's exercise of its right of setoff, however, is more like a creditor's levy than a consensual transfer,¹⁴³ and section 72.2 provides that trust assets shall not be levied upon as the individual property of the trustee. This is consistent with the view expressed by the Court of Appeals in *Aquilino v. United States*,¹⁴⁴ in which it was held that federal tax liens filed against a contractor could not be enforced against contractor trust assets (namely, amounts due from the owner) ahead of trust beneficiaries' claims:

[A] contractor does not have a sufficient beneficial interest in the moneys, due or to become due from the owner under the contract, to give him a property right in them, except insofar as there is a balance remaining after all subcontractors and other statutory beneficiaries have been paid.¹⁴⁵

CONCLUSION

Banks and other entities that provide financing for persons involved in private or public improvement projects run the risk that their activities will expose them to liability for diversion of Lien Law Article 3-A trust funds, whether or not the advances they make to such persons are made in relation to such improvements. Generally,

141. See *Northern Structures, Inc. v. Union Bank*, 57 A.D.2d 360, 366-67, 394 N.Y.S.2d 964, 968-69, *amended*, 58 A.D.2d 1042, 396 N.Y.S.2d 1021 (1977); *Utica Sheet Metal Corp. v. J. E. Schecter Corp.*, 53 Misc. 2d 284, 286, 278 N.Y.S.2d 345, 348 (1967).

142. N.Y. LIEN LAW § 72.1 (McKinney 1966). See *supra* text accompanying notes 79-81.

143. Cf. U.C.C. §§ 1-201(32) (1987) ("Purchase" includes . . . any . . . voluntary transaction creating an interest in property"); 9-104(i) (1987) ("[Article 9] does not apply to any right of set-off"). *But cf.* *Gerrity Co. v. Bonacquisti Constr. Corp.*, 136 A.D.2d 59, 63, 525 N.Y.S.2d 926, 929 (1988) (setoff by Norstar discussed as a "[t]ransfer by the trustee").

144. 10 N.Y.2d 271, 176 N.E.2d 826, 219 N.Y.S.2d 254 (1961).

145. *Id.* at 282, N.E.2d, N.Y.S.2d. Although the court was construing Lien Law section 36-a, a predecessor of section 72, such qualified ownership is still valid, albeit subject to Lien Law §§ 72 and 73. See *St. Paul Fire and Marine Ins. Co. v. State*, 99 Misc. 2d 140, 415 N.Y.S.2d 949 (Ct. Cl. 1979) (state held guilty of diversion when it levied upon funds owed by the owner to the contractor for unpaid state taxes not accrued on the particular improvement). Cf. *Utica Sheet Metal Corp. v. J.E. Schecter Corp.*, 53 Misc. 2d 284, 278 N.Y.S.2d 345 (Sup. Ct. 1967) (court suggested the *Aquilino* rule as alternative to imputing notice of trust assets to a bank (for purpose of finding diversion by bank setoff) but found no diversion because the trust funds were already withdrawn at the time of setoff). Certainly there is no indication in *Aquilino* itself that notice *vel non* of the trust on the part of the government was material.

any such entity has a defense to diversion if it qualifies as either a holder in due course of a negotiable instrument or a bona fide purchaser for value without notice that the transfer to him is a diversion. Even with notice that its activities involve assets of an Article 3-A trust, however, an entity may qualify for the defense of Lien Law section 73, which requires that a "Notice of Lending" be filed and that a trust covenant be procured from the trustee. An entity that fails to qualify for, or to satisfy, section 73 should be able to avoid liability if it can show that the complainant had notice of its activities, apart from the notice of lending, and that its advances to the trustee were actually applied for trust purposes.

In the case of a bank that sets off debts of the trustee against the latter's account with the bank, there should be a duty of inquiry imposed upon the bank regarding the character of the funds in the account, once the bank is chargeable with notice of the trustee status of the account owner. A failure of such duty should lead to bank liability to the extent that, by application of the first in, first out rule, trust funds are found to have been in the account at the time of setoff. When the claimed diversion from the trust account is by the trustee himself, however, effected by withdrawals from the account and the application of the proceeds to non-trust purposes, the bank may avoid liability as a 'participant' in the diversion, unless the notice chargeable to the bank extends to the trustee's diversionary activities.

