



AGC Legal Brief

Published by the AGC of Michigan

Volume VI, Issue 2 -- 2010

Michigan Court of Appeals Reaffirms Personal Liability of Corporate Officers under the Michigan Builder's Trust Fund Act

by Peter J. Cavanaugh

pcavanaugh@cqlawfirm.com

INSIDE THIS ISSUE:

Michigan Court of Appeals Reaffirms Personal Liability of Corporate Officers under Michigan Builder's Trust Fund Act

Local Residency Requirements: Are They Legal?

LEGISLATIVE UPDATE

- Michigan's Smoking Ban
- Statute of Limitations

How to Verify that a Payment or Performance Bond Complies with Michigan's Public Bond Statute

These articles were submitted by:

Peter J. Cavanaugh
 Cavanaugh & Quesada, PLC
 1027 S. Washington Ave., Ste A
 Royal Oak, MI 48067
 T: (248) 543-8320
 F: (248) 543-8330
 C: (248) 752-1121
 pcavanaugh@cqlawfirm.com
 www.michiganconstructionlaw.com

These articles are intended to highlight a specific area of the law. This communication is not legal advice. The reader should consult an attorney to determine how the information applies to any specific situation.

Proof that a corporate officer personally misappropriated contract proceeds "is not necessary to find an officer liable" for a violation of the Michigan Builder's Trust Fund Act (MCL 570.151, et seq). "[A] reasonable inference of appropriation arises from the payment of construction funds to a contractor and the subsequent failure of the contractor to pay laborers, subcontractors, materialmen, or other entitled to payment." So declared the Michigan Court of Appeals recently in another decision affirming the principal (and risk) of personal liability for the owners of construction companies under the Michigan Builder's Trust Fund Act (MBTFA).

In *BC Tile & Marble Co v Multi-Bldg Co.*, 2010 Mich App LEXIS ____ (Mich Ct App, April 13, 2010), the defendant general contractor built and sold a condominium (Unit 5) to a homeowner. Although the contractor received funds at the closing for Unit 5 to pay his tile and marble subcontractor, the contractor failed to pay the subcontractor citing defective workmanship and delayed performance. The subcontractor, who had recorded and served a construction lien four days prior to the closing, then filed suit to foreclose his lien, and included a claim against the contractor's president, in his individual capacity, for violation of the MBTFA.

The MBTFA provides that upon receipt of payment from the owner, a trust is created for the benefit of contractors, laborers, subcontractors and suppliers, and makes the contractor or subcontractor who receives the payment a trustee of the funds. The MBTFA is a criminal statute, but the courts have also recognized a civil cause of action under common law. To make out a civil cause of action under the MBTFA, a plaintiff must establish the following elements:

- The defendant is a contractor or subcontractor engaged in the building construction industry,
- The defendant was paid for labor or materials provided on a construction project,
- The defendant retained or used those funds, or any part of those funds,
- The funds were retained for any purpose other than to first pay laborers, subcontractors, and materialmen, and
- The laborers, subcontractors and materialmen who were engaged by the defendant to perform labor or furnish material for the specific construction project.

See, *Livonia Bldg Materials Co v Harrison Construction Co*, 276 Mich App 514, 519 (2007).

In *BC Tile*, the plaintiff asserted that the president of Multi-Bldg Co. was personally liable because he had signed the closing documents that allowed payment to other contractors, but not BC Tile. The president responded and denied that he had any day-to-day involvement with or exercised any decision-making for the particular condominium project, and denied that he had personally received any of the funds at closing. While the Court of Appeals agreed that "there is no evidence here that [the president] personally used the funds owed to BC Tile," it found that this was not dispositive of the MBTFA claim.

First, the Court reiterated its decision in the appeal of a criminal prosecution under MBTFA: "there is no requirement that contract payments be made directly to the officer of the corporate contractor in order to hold the officer individually responsible under the MBTFA." *People v Brown*, 239 Mich App 735, 743-744 (2000).



**Michigan Court of Appeals Reaffirms Personal Liability
of Corporate Officers under the Michigan Builder's Trust Fund Act** (continued)

Second, relying on a 2007 decision involving civil claims, the Court of Appeals noted:

"In *Livonia Bldg*, the defendant contractor received funds for a project but did not pay the plaintiff in full. The corporate officers gave testimony regarding their decision to put the funds received in various accounts and subsequently, their actions in writing checks to entities other than the plaintiff. This Court found that the individual corporate officers 'acted in direct contravention of the MBTFA.' According to this Court, there was sufficient evidence to create a presumption of misappropriation and to find the corporate officers individually liable."

The Court of Appeals concluded that the president of the construction contractor should not have been granted summary disposition, and reversed the trial court's ruling. The corporate officer thus faces a trial and possibly a personal judgment.

Not addressed in the Court's decision, but another significant issue for individual defendants, is the impact a trust fund claim may have on a personal bankruptcy. Since the statute is predicated on the existence of a trust, a violation of the MBTFA is also breach of the (contractor) trustee's fiduciary duties. Under the bankruptcy code, fraudulent conduct while acting in a fiduciary capacity is known as "defalcation," and is one of the specified grounds for excluding a claim from discharge. Said another way, a Builder's Trust Fund Act claim is a debt that can survive a bankruptcy when most other claims are discharged.

To avoid such long term personal liabilities, contractors must take care in these turbulent economic times to address shortfalls in payment with subcontractors and suppliers by securing waivers and releases that include officers and shareholders, especially when making compromise payment agreements, and documenting the reasons for non-payment to subcontractors and suppliers where facts and circumstances warrant the withholding of payment.

Local Residency Requirements: Are They Legal?

by Peter J. Cavanaugh

pcavanaugh@cqlawfirm.com

In 2007, the City of Detroit issued Executive Order 2007-01, which requires the use of 51% city residents on Detroit contracts. In 2008, the City of Lansing adopted Executive Order 2008-03, which created incentives for use of Lansing-based businesses and employees. In 2009, Genesee County announced plans for a new \$600 million water pipeline, and recently began discussing a requirement that 75% of the labor hours for the project come from Genesee County and other member communities.

In these economic times, creating employment preferences for local residents on public construction projects is a natural reaction and an easy decision by local politicians. After all, if local taxpayers are footing the bill for a bond issue, why shouldn't they move to the front of the hiring line? While such preferences have popular appeal, they raise an interesting legal question: Are residency requirement ordinances legal? The short answer is this: It all depends on the legal grounds for challenging the residency ordinance.

Recent efforts to give preference to local residents are similar to efforts made during previous economic downturns. In 1980, for example, the City of Camden (NJ) adopted an ordinance requiring that at least 40% of employees of contractors and subcontractors working on city funded construction projects be residents of the City of Camden. Like Detroit, the City of Camden in 1980 argued that the ordinance was necessary to combat "grave economic and social ills" such as "spiraling unemployment." The ordinance was quickly challenged in court.

The plaintiffs in the Camden case asserted that the City's ordinance was unconstitutional. The plaintiffs cited both the Commerce Clause and Privileges and Immunities Clause of the U.S. Constitution. *United Bldg & Constr Trades Council v Mayor & City Council of Camden, et al.*, 465 US 208; 104 SCt 1020 (1984). While the Camden case was pending, in 1983, the U.S. Supreme Court upheld a challenge to a City of Boston executive order, which required that at least 50% of all jobs on construction projects be filled by *bona fide* Boston residents.

The Boston executive order was challenged (and upheld) under the Commerce Clause. The Privileges and Immunities Clause, however, presents a different set of issues, and could lead to a different outcome.

Although it is one of the more arcane provisions of the U.S. Constitution, the Privileges and Immunities Clause is relatively straight forward: "The Citizens of each State shall be entitled to all [the] Privileges and Immunities of Citizens of the several states." (Article IV, s. 2) The purpose of the Privileges and Immunities Clause is to insure that the citizens of State A who enter State B receive the same treatment and benefits as other citizens of State B.

In *Camden*, the U.S. Supreme Court applied a two-step test when examining whether a particular ordinance discriminates against out-of-state residents. First, the Court looks to see whether the ordinance affects (burdens) one of those privileges and immunities protected by the Constitution. In the Camden case, the Court found that employment was a protected privilege. Second, the Court looks to see whether there is a substantial reason for the difference in treatment between citizens of different states.

Local Residency Requirements: Are They Legal? (continued)

The *Camden* Court did not decide the constitutionality of Camden's ordinance because there had not been sufficient facts developed at the trial court level to allow the Court to apply the two-step test. The *Camden* decision, however, established precedent followed by other courts.

In 1997, the *Camden* decision was relied upon to strike down a Pennsylvania requirement that Pennsylvania contractors could only hire Pennsylvania laborers and mechanics on state-funded projects. See, *A L Blades & Sons, Inc v Yerusalim*, 121 F3d 865 (3rd Cir, 1997). And in 2002, the *Camden* decision was the basis for a federal lawsuit brought against the City of Worcester (MA), which had passed a 50% residency requirement ordinance. The U.S. District Court initially granted the plaintiffs a preliminary injunction and later a permanent injunction against enforcement of the ordinance. *Utility Contractors Ass'n of New England v City of Worcester*, 236 FSupp 2d 113 (2002). The *Worcester* court relied upon the Privileges and Immunities Clause and the test outlined in the *Camden* decision.

Thus, a successful challenge to a local residency requirement depends upon the constitutional grounds used to advance such a challenge. Such a claim should be brought by an out-of-state resident, denied employment due to the local ordinance, under the Privileges and Immunities Clause. Given the constitutional nature of the claim, it can be brought in federal district court, which may also insulate the claim from local pressures.

LEGISLATIVE UPDATE — Michigan's Smoking Ban

by Peter J. Cavanaugh

pcavanaugh@cqlawfirm.com

In December, 2009, the Michigan Legislature passed the Michigan Smoke Free Law (2009 PA 188 or the "Dr. Ron Davis Law"), which amends Part 126 (*Smoking in Public Places*, MCL 333.12601 et seq.) and Part 129 (*Food Service Establishments*, MCL 333.12901 et seq.) of the Public Health Code.

Effective May 1, 2010, individuals cannot smoke in "public places," which include "places of employment" (enclosed indoor areas that contain 1 or more work areas for 1 or more persons employed by a public or private employer) and "food service establishments." The law covers commercial office buildings, malls, restaurants, and the indoor common areas of apartment and condominium buildings. The law exempts casinos, cigar bars, and tobacco specialty stores existing on May 1, 2010.

There is nothing in the law regarding distance requirements for smoking *outside* of a building—however, there may be local ordinances that specify distance requirements.

What is the impact on contractors in Michigan? In a word: Confusion.

While the new law defines "Place of employment" as "an enclosed indoor area that contains 1 or more work areas for 1 or more persons employed by a public or private employer," suggesting that smoking might be permissible up to the point a building is enclosed, the term "enclosed" is not defined creating ambiguity. At what point during the construction process does a building become "an enclosed indoor area"? Is it when the roof is installed? Windows placed? The new law is unclear. Smoking in a job trailer, however, would appear to be covered by the statute, and thus prohibited.

In addition, the new anti-smoking law includes a very broad definition of "public place," which includes not only "enclosed, indoor area[s] owned or operated by a state or local governmental agency and used by the general public," but also includes private facilities that are used by the general public, such as educational facilities, arenas, theaters, and concert halls. When does a new construction project become a "public place"? Upon substantial completion? Unclear. Upon the issuance of a Certificate of Occupancy? Yes, probably.

LEGISLATIVE UPDATE — Statute of Limitations

by Gary D. Quesada

gquesada@cqlawfirm.com

In 2006, the Michigan Supreme Court issued its ruling in *Ostroth v Warren Regency*, which changed existing law and practice concerning the time period during which claims could be brought against contractors and design professionals. The *Ostroth* decision significantly lengthened the statutes of limitation for the design and construction industry for claims of defective and unsafe conditions arising out of improvements to real property. The longer statutes of limitation created by the *Ostroth* decision run counter to Michigan's strong public policy of preventing stale claims, and requiring claimants to assert their rights in a timely manner. Under the new rule created by *Ostroth*, a claimant that believes it has a claim against a contractor can often wait more than six years to file its lawsuit without any penalty.

To address the confusion and instability in the construction industry caused by *Ostroth*, AGC of Michigan and its allies have promoted legislation that would address this ruling. In 2009, Senator Alan Sanborn (R-Richmond) introduced the latest statute of limitations reform bill, known as SB 882, which would re-establish the former law and return the statutes of limitation to their shorter periods. SB 882 enjoys broad bi-partisan support in the Michigan Legislature. On December 1, 2009, SB 882 passed the Senate on a 36-0 vote. In the House, SB 882 is currently scheduled for a hearing on May 19, 2010, before the Judiciary Committee chaired by Representative Mark Meadows (D-East Lansing).



Thomas M. Keranen, Committee Co-Chair
Clark Hill, PLC, Detroit

Stephen A. Hilger, Committee Co-Chair
Hilger Hammond PC, Grand Rapids

Gabriela Ban, Walbridge, Detroit
Stan Buell, Grand River Construction, Hudsonville

Peter Camps, Nemeth Burwell, P.C., Detroit

Peter Cavanaugh, Cavanaugh & Quesada, Royal Oak

Joseph DeLave, Dickinson Wright, PLLC, Bloomfield Hills

Tom Dyze, Walbridge, Detroit
Pat Facca, Facca, Richter & Pregler, Troy
Steve Frederickson, The Christman Company, Lansing

Martin Frenkel, Maddin, Hauser, Wartell, Roth & Heller, Southfield

Scott Graham, Scott Graham PLLC, Kalamazoo

Ben Hammond, Hilger & Hammond, Grand Rapids

David Hayes, Clark Hill, PLC, Lansing
Scott Hechlik, Osprey Construction, Brighton

Kevin Hendrick, Clark Hill, PLC, Detroit
David Houston, Dickinson Wright, PLLC, Lansing

Susan Koval, Nemeth Burwell, P.C., Detroit

Aileen Leipprandt, Miller Johnson, Grand Rapids

David M. Lick, Foster Swift Collins & Smith, Lansing

Frank Mamat, Foster Swift Collins & Smith, Farmington Hills

Mark McAlpine, McAlpine & McAlpine, PC, Auburn Hills

Brian Moore, Moore Trospier Construction, Holt

Chris Parfitt, Deneweth, Dugan & Parfitt, PC, Troy

Ted Peters, Sullivan Ward Asher & Patton, Southfield

Tom Porter, Tom Porter Services, Grosse Pointe

Bob Rabeler, Soil & Materials Engineers, Grand Rapids

Gary Reeves, Bodman LLP, Troy
James Schmid, Grant Thornton LLP, Southfield

Dennis Schultz, Dawda, Mann, Mulcahy & Sadler, Bloomfield Hills

John Sier, Kitch, Drutchas, Wagner, Denardis & Valitutti, Detroit

Neil Steinkamp, Stout Risius Ross, Inc., Southfield

John Tesija, Novara Tesija, Southfield

Jeff Theuer, Loomis Ewert Parsley, Davis & Gotting, Lansing

Ron Torbert, Barton Malow Co., Southfield
Staff Representative: **Claudia Jefcoat**

How to Verify that a Payment or Performance Bond Complies with Michigan's Public Bond Statute

by Peter J. Cavanaugh pcavanaugh@cqlawfirm.com

Michigan's public works bond statute (MCL 129.201, et seq)¹ requires that a principal contractor furnish a payment and performance bond executed by a surety authorized to do business in Michigan. Public owners have a legal duty² to verify the validity of a payment bond furnished by a contractor on a public works project. And many contracts also require that the contractor or subcontractor furnish payment and performance bonds, which are executed by a surety listed on Treasury Circular 570.

If you receive a contractor or subcontractor's bond, how do you know whether it complies with these requirements? How do you check on a bonding company whose name doesn't sound familiar? How do you verify the financial strength of a surety?

While you can call your bonding agent, there are three (3) easy ways to verify basic information about a surety using readily available online resources.

1. State of Michigan

The State of Michigan, Office of Financial and Insurance Regulation (OFIR) maintains an online database of insurance companies³ that are registered to conduct business in the State of Michigan. The search interface is somewhat confusing, but if you search using the last field on the form, you should be able to find the surety you are looking for. If you don't find the surety, it means they are not registered to conduct business in Michigan. Take such a finding as a red flag.

For insurance companies that are registered to conduct business in Michigan, you get the usual information about state of incorporation, and registered agent. Below is a sample report for Hartford Fire Insurance Company⁴, a surety that is active in Michigan.

2. Treasury Circular 570

Treasury Circular 570⁵ is a list of acceptable sureties on federal bonds maintained by the U.S. Department of Treasury. A surety that isn't on this list is probably very small, or one that should not be accepted or relied upon. It raises a red flag in my mind when I don't find a surety on this list.

Michigan law generally provides little recourse to potential bond claimants in the event that a contractor fails to furnish a bond, or furnishes one that fails to comply with the statute. Failure to furnish a bond that comports with the statute, however, would probably be grounds for an owner to terminate a contract.

3. A.M. Best Company

A.M. Best [www.ambest.com] is a company that issues financial-strength ratings measuring insurance companies' ability to pay claims. If the contract requires that a surety bond be furnished by a surety with a particular rating (ie., AA or B+), you can verify this rating online through A.M. Best.

NOTES:

[1] <http://legislature.mi.gov/doc.aspx?mcl-Act-213-of-1963>

[2] Kammer Asphalt Paving Co v East China Twp, 443 Mich 176, 191 (1993).

[3] http://www.dleg.state.mi.us/fis/ind_srch/ins_comp/insurance_company_criteria.asp

[4] http://www.dleg.state.mi.us/fis/ind_srch/ins_comp/insurance_company_detail.asp?id=0000241

[5] http://fms.treas.gov/c570/c570_a-z.html

Published by the AGC of Michigan

Lansing Office
2323 N. Larch Street
LANSING, MI 48906
Phone: (517) 371-1550

Detroit Office
26001 Five Mile Road
REDFORD, MI 48239
Phone: (313) 533-3509