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IN PRACTICE

CONSTRUCTION LAW

Supplier's Allocation-of-Payment Obligations Under Construction Lien Law

Appellate court provides direction in *L&W Supply Corp. v. DeSilva*

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Your material supplier calls you seeking your counsel. It has received a payment from a company to whom it supplied materials without any direction on which of several project accounts the payment should be applied. What are the material supplier's obligations regarding allocating this payment among its open accounts? May it apply this payment to a project debt where it does not have enforceable rights to file a construction lien, thereby leaving unpaid the debt on a project where it has an ability to file a construction lien? If it does, what are the consequences for the enforceability of its subsequently filed construction lien?

In *Craft v. Stevenson*, 179 N.J. 56 (2004), the New Jersey Supreme Court held a supplier had an obligation to apply the payment to the construction project from which it knew, or had reason to know, the payment emanated. Under *Craft*, if the supplier failed to apply the payment to the project when it knew or had reason to know the payment derived from that project, it forfeited its lien rights on the project. After *Craft*, questions remained regarding: (1) whether the supplier had an affirmative duty to inquire about the source of the payment if the payment was not accompanied by information tying it to a specific project; and (2) the circumstances under which a supplier could accept direction from the payor on the application of the payment to a specific project or debt. In the absence of answers to these questions, material suppliers faced substantial uncertainty about the enforceability of constructions liens they filed based on their allocation of such payments to other projects.

In *L&W Supply Corp. v. DeSilva*, 429 N.J. Super. 179 (App. Div. 2012), the court provided clear direction on these two open questions. First, the *L&W Supply* court held that, in light of the obligation on suppliers to ascertain the source of the payment in order to allocate it correctly as articulated in *Craft*, the supplier has an affirmative, active obligation to inquire about the source of the payment. Absent undertaking this inquiry, a supplier may be held to have constructive knowledge that the payment should have been applied to the project against which it subsequently files a construction lien. Second, the supplier is permitted to apply the payment per the specific instructions of the payor, unless the supplier has a reason to suspect this will result in an improper allocation, in which event, the supplier's affirmative inquiry obligation is triggered.

In *L&W Supply*, a subcontractor had purchased metal studs, drywall and related materials from L&W Supply pursuant to the subcontractor's contract with the prime contractor responsible for the construction of an assisted living facility in Wall, N.J. The subcontractor received payment from the general contractor for the materials supplied by L&W Supply. When L&W Supply received subsequent payments from the subcontractor, with whom it had several open accounts, it applied the payments to the oldest accounts given the absence of direction from the subcontractor that the payments should be applied to the assisted living facility project. After the subcontractor filed for bankruptcy, leaving its bill from L&W Supply unpaid for materials supplied to the assisted living facility, L&W Supply filed a construction lien against the project.

The trial court granted summary judgment to L&W Supply on its construction lien. The Appellate Division reversed, ruling that the conclusory certifications L&W Supply had submitted alleging its proper allocation of the subcontractor's payments were insufficient to eliminate questions of fact regarding whether L&W Supply knew or should

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have known that the source of the payments emanated from the assisted living project, or regarding whether L&W Supply had satisfied its affirmative duty to inquire into the source of these payments. The Appellate Division remanded the case for a trial on those issues.

The affirmative duty of inquiry articulated in *L&W Supply* is based on the application of the policies behind the New Jersey Construction Lien Law (CLL), N.J.S.A. 2A:44A-1, et seq., to common-law principles regarding application of payments.

Under the longstanding "payment application rule," a creditor who is owed more than one debt by a debtor is permitted to apply the payments to the account in any manner it chooses, absent specific instructions by the debtor to the contrary. *United Orient Bank v. Lee*, 208 N.J. Super. 69, 72 n.1 (App. Div. 1986).

An exception to this rule in the context of payments on a public construction project was recognized in *Hiller & Skogland v. Atl. Creosoting Co.*, 40 N.J. 6 (1963). Hiller involved a supplier's failure to properly allocate a payment down the contracting chain when it applied the payment to the oldest accounts owed by the subsequently insolvent subcontractor. Recognizing that all payments made down the contracting chain on New Jersey public projects constituted trust funds under the Trust Fund Act, N.J.S.A. 2A:44-148, the Supreme Court held that the supplier was obligated to apply the payment to the public project account if it knew or should have known the payment derived from the public contract. In so ruling, the *Hiller* court referred to the section of the *Restatement of Contracts* obligating a creditor to apply a payment to a particular account if it knew or should have known that the payor was under a duty to a third party to devote those monies to discharge a debt related to that account.

In *Craft*, the Supreme Court referred to the successor to the same section of the *Restatement of Contracts* in conjunction with the policies of the CLL. The *Craft* court referred to payments made down the contracting chain under the CLL as assets of a trust, citing the declaration in the Sponsor's Statement to the CLL that the law would "eliminate the age-old problem of 'pyramiding' in which construction monies from one project are used to finance other jobs…." This is consistent with the policy under the CLL to protect owners against paying more than once for the same work or materials, as recognized by the court in *Labov Mech. v. E. Coast Power*, 377 N.J. Super. 240, 245 (App. Div. 2005), and in the limitation of construction liens to the "lien fund," now defined in the CLL at N.J.S.A. 2A:44A-2.

These policies mandate the reciprocal duties for subcontractors to properly earmark payments made to suppliers from project proceeds, and for suppliers to allocate those payments to the project debt if they know or should know the project is the source of the payment. *Craft* at 75-76. Any supplier wishing to file a construction lien claim where it has received unearmarked payments and has applied them to other account debts is prevented from doing so unless it has ascertained the source of all such payments and determined their source is not the project to be liened. Unless the supplier complies with this duty, it is unable to execute the statutorily required verification of the debt in the lien claim.

L&W Supply recognized that courts in most other states considering this issue, and even the court in *Hiller*, refused to impose anything more than a passive allocation of payments duty on a supplier regarding whether it knew or had reason to know that the source of the payment emanated from a particular project. In the final analysis, however, the court in *L&W Supply* could not reconcile such a passive duty with the policies behind the CLL as articulated in *Craft*.

Complying with this affirmative duty of inquiry about the source of the payment may prove challenging to suppliers. Even in cases where the payor has provided instructions about applying the debt to a specific account or project, the supplier is not excused from this obligation if it has some "reason to suspect improper allocation of funds." *L&W Supply* at 191. Presumably courts will use an objective standard of a "reasonably suspicious person" to determine if the supplier has complied with this duty. The court in *L&W Supply* declared that such an inquiry need not be made in every case where the payor has given specific allocation instructions. However, given the multitude of circumstances that might constitute a reason for such a suspicion — especially with the benefit of 20/20 hindsight, and the likelihood this will be deemed a fact issue precluding summary judgment — it would behoove suppliers to have a standard inquiry procedure in place with respect to the allocation of all payments received from debtors with more than one project account, even those payments accompanied by application instructions. Such a procedure might include questioning the payor, the general contractor and/or the owner of the property regarding the source of the payment, methods suggested by the court in *L&W Supply*. Whatever procedure suppliers and their counsel devise, it should be done with a view toward the strict time limitations for lodging construction liens for record with the county clerk and the need to present documentation of the inquiry in any subsequent lien enforcement proceeding.

The decision in *L&W Supply* provided much needed clarification on the scope of a supplier's duty regarding allocation of payments and their consequences for the enforceability of construction liens filed based on such allocations. The decision, however, left some open questions. One is whether a construction lien filed based on an improper allocation might expose the supplier to liability for attorneys' fees and damages under N.J.S.A. 2A:44A-15.a. Another is whether the payment allocation duties set forth in *L&W Supply* apply with equal force to prime contractors and subcontractors. The policies of the CLL and the reasoning in both *Craft* and *L&W Supply* suggest an affirmative answer to both questions. ■