

## IN PRACTICE

## CONSTRUCTION LAW

### A Duty To Inquire Under Lien Law

Obligations imposed on suppliers to allocate payments correctly

By Peter J. Torricollo and  
Damian V. Santomauro

Suppliers of construction materials are often utilized by contractors on multiple, contemporaneous projects. In such circumstances, it is not always clear to which project a supplier should apply payments by a specific contractor, particularly absent specific direction from the contractor and/or diligent record-keeping by all parties. Critically, as demonstrated by the recent appellate decision in *L&W Supply Corp. v. DeSilva*, 2012 N.J. Super. LEXIS 189 (App. Div. Dec. 19, 2012), a supplier's failure to take appropriate steps to ensure that payments are accurately applied to the correct project can have significant, adverse consequences on the ability of the supplier to subsequently enforce its rights under New Jersey's Construction Lien Law, N.J.S.A. § 2A:44A-1, et seq.

As a general matter, "a creditor who is owed more than one debt by a debtor may apply the payments to the debtor's account in any manner it chooses so long as the debtor has not issued specific directions to the contrary." *Craft v. Stevenson Lumber Yard*, 179 N.J. 56, 72 (2004). This

*Torricollo and Santomauro are directors in the business and commercial litigation department of Gibbons PC in Newark.*

common-law "payment application rule," however, is not absolute, and does not apply in the context of construction lien claims. Indeed, as the New Jersey Supreme Court held in *Craft*, the Construction Lien Law negates the payment application rule and imposes an obligation on a third-party creditor to specifically apply payment on the accounts from which they were derived if the creditor wishes to file a construction lien claim. Specifically, the court stated:

When ... the creditor knows or should know that a debtor is under an obligation to a third party to devote a relevant payment to discharge a duty the debtor owes to the third party, the payment must be applied to do so regardless of the debtor's instruction or lack thereof.

In *Craft*, the court held that a supplier's lien claim should have been dismissed as a matter of law because the supplier "knew or had reason to know that it was not free to apply [the contractor's] payments at will" and that the supplier "was obligated to ascertain the source of [the contractor's] payments to apply them accordingly." While the *Craft* court did not specify what steps a supplier is required to take in order to satisfy this obligation, the Appellate Division, in *L&W Sup-*

*ply Corp.*, directly addressed this issue.

*L&W Supply Corp.* involved a lien claim filed by L&W Supply Corp. in connection with the construction of an assisted living facility owned by Extended Medical Care Corp./Meridian Health/Meridian Nursing & Rehabilitation ("Meridian"). Meridian hired Patock Construction Co. as the general contractor, and Patock in turn hired Detail Contractors, Inc., owned by Joseph DeSilva, as the subcontractor to perform metal stud, drywall and carpentry work. DeSilva maintained an account with L&W that allowed him to obtain materials on credit for his various business entities, including Detail. L&W supplied materials to Detail in connection with the Meridian Project.

L&W sold \$231,794.34 worth of materials to Detail on credit for use on the Meridian project. During the course of that project, Detail paid L&W \$207,000, and another DeSilva entity paid L&W \$10,000. L&W applied \$103,959.45 to the Meridian project and \$113,040.55 to other accounts that DeSilva had with L&W. When Detail failed to pay the full balance due, L&W filed a construction lien against the Meridian project in the amount of \$127,834.89 and filed litigation against Meridian, Patock, DeSilva and his business entities, and the surety that posted a bond to discharge the construction lien.

The trial court ultimately granted summary judgment in L&W's favor in the full amount of the lien. The defendants appealed, arguing that the

amount of L&W's lien claim should only have been \$12,143.05, because L&W had wrongly applied payments from Detail to projects other than the Meridian project. On appeal, the Appellate Division reversed the trial court's decision and held that there were disputed factual issues relating to how L&W applied its payments, which precluded summary judgment for L&W. Specifically, the court stated that L&W had not presented evidence of the affirmative steps that it took to ensure that it was properly applying payments from Detail and the other DeSilva entities to the correct projects.

In reaching its decision, the appellate court explained "the lengths to which a supplier must go to discharge its *Craft* duty to allocate payments accurately," and set forth the "circumstances that give a supplier 'reason to know'" that it was not free to apply a contractor or subcontractor's payments at will. Specifically, the court determined that because a supplier has an obligation to allocate payments correctly, it must inquire about the source (i.e., the project) of the payments it receives. Rejecting a more passive duty that had been adopted by courts in other jurisdictions, the court stated that "[t]o ascertain the source of funds, a supplier must take some action, and an inquiry about the source of the funds is the most obvious action to take." Significantly, the court suggested that the supplier's duty requires not only an inquiry of the purchaser with whom the supplier contracted, but also may necessitate "contacting prime contractors or owners of projects to which it delivered" to ensure that it is applying the purchaser's payment correctly.

Recognizing that there are potential adverse business consequences if suppliers are compelled in all circumstances to make inquiries of their customers that at least implicitly suggest potential impropriety, the court expressly held that the duty to inquire about the source of payments does not arise any time a supplier receives a

payment. Rather, the court established a rubric that suppliers can utilize to comply with the *Craft* obligation to apply payments correctly. The rubric turns on whether "the supplier has reason to suspect that something is amiss in the material purchaser's allocation of payments to different accounts." That is, a supplier's duty to inquire about the source of payments is triggered where: (1) the purchaser of the materials does not provide "specific, reliable instructions regarding the allocation of its payment"; or (2) the circumstances reflect that "a reasonable supplier should suspect that the purchaser has not used an owner's funds to pay for materials supplied for that owner." If either of these circumstances exists and the supplier fails to make further inquiry, resulting in payments being misapplied, the supplier will forfeit its rights under the Construction Lien Law.

Applying its holding to the facts developed before the trial court, the appellate court noted that, although L&W had submitted witness certifications attesting that all of the monies L&W received from the DeSilva entities from Patock payments for the Meridian Project were applied to that project, these witnesses had not provided any calculations or other details demonstrating how they made that determination. Because Patock had submitted evidence that a significant amount of the money that Detail paid was applied to non-Meridian projects, the court held that there was a factual issue as to whether L&W had satisfied its obligation to ascertain the sources of the funds from which Detail and DeSilva were making payments to L&W. The court noted that, on remand, issues regarding any direction DeSilva provided to L&W regarding how to apply payments, and whether L&W had any reasons to suspect that DeSilva and his business entities might be misapplying payments could be explored. The court further noted that the defendants should be permitted an opportu-

nity to prove that L&W was required to make an inquiry about the source of the funds but failed to do so.

The *L&W Supply Corp.* decision highlights some of the challenges confronting suppliers that provide materials to customers engaged in multiple construction projects. Detailed record-keeping by the supplier is obviously important, but the *L&W Supply Corp.* opinion makes clear that the Construction Lien Law imposes more onerous requirements where circumstances so dictate. As such, it is incumbent upon suppliers to assess payments by purchasers to determine whether the purchaser is directing application of a payment to the proper account or whether the circumstances give rise to an objectively reasonable suspicion that the purchaser is not using the proper funds to pay for materials for a particular project. Where reliable instruction is not provided or suspicion exists regarding the source of the funds, an inquiry must be made as to the source of the payments. While the *L&W Supply Corp.* decision does not specifically define the scope of the required inquiry, suppliers should, at a minimum, make a diligent inquiry of the purchaser and, if that does not quell any suspicion, undertake alternative measures to investigate the source of the purchaser's payment. Such alternative measures may potentially include contacting other parties involved on the projects to which it supplied materials to attempt to confirm the source of the payment.

While failure to comply with the dictates of *Craft* and *L&W Supply Corp.* will not preclude aggrieved suppliers from pursuing all potential causes of action, it can result in the forfeiture of the valuable construction lien rights provided by the Construction Lien Law. Accordingly, prudent suppliers should endeavor to be cautious when applying payments by purchasers, and take necessary steps to satisfy themselves that the payments are being applied to the correct project. ■