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Beneficiaries of Contractor's Trust Trump IRS Tax Levy

In a recent decision, New York's Appellate Division held that the State was liable to a surety for wrongfully surrendering monies due under a public improvement contract in response to an IRS tax levy. The Court held that the contractor did not own the money, but only held a right to claim it in trust for the benefit of persons contributing work or material toward the contract's completion, pursuant to Article 3-A of the N.Y. Lien Law. *Kemper Ins. Companies v. State of New York*, 892 N.Y.S.2d 596, 2009 N.Y. Slip Op. 10032 (3d Dep't 2009).

In this case, Kemper Insurance Companies had issued payment and performance bonds on behalf of Hasley Construction, on a State contract to reconstruct certain roads. About a year later, Hasley defaulted on the contract. At that time, \$579,779.68 remained due under the contract. The State terminated Hasley's contract, and entered into a takeover agreement with Kemper. Kemper was to complete the work and the State was to pay Kemper all amounts payable under the contract, including the amount due at the time Hasley defaulted. Thereafter, the IRS served the State with a tax levy, seeking to recover money due Hasley for outstanding tax obligations. The State paid the IRS the \$579,779.68, although it had agreed to pay the money to Kemper.

Kemper completed the work and demanded payment under the agreement, but the State claimed it did not owe the \$579,779.68 because it had already paid that money to the IRS on Hasley's behalf. Kemper filed a notice of claim in the Court of Claims and then pursued a wrongful levy action against the IRS in federal court. It recovered all but \$235,885.78, and it sought the difference from the State. The State argued that federal law immunized it from liability because it had honored the tax levy in good faith, but Kemper argued that the State's failure to make reasonable inquiry about Hasley's title to the money deprived it of immunity. Moreover, Kemper argued, 26 C.F.R. 301.6332-1(c)(2) provides a party who has surrendered property to the IRS in response to a tax levy "is not relieved of liability to a third party who has an interest in the property." Both parties requested summary judgment and the Court ruled for the State, finding that Kemper's sole remedy was an action against the Federal government for wrongful levy.

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On appeal, the Third Department ruled that under Article 3-A of the N.Y. Lien Law, Hasley had no more than a right to claim the money which it held in trust for the benefit of subcontractors and suppliers. Such a trust consists not only of amounts already due a contractor, but also of the right to amounts that accrue under the contract in the future. The use of such trust money for any purpose other than the payment of trust claims (i.e., claims of those who provided labor or material to complete the contract) is a diversion of trust assets.

Relying on a prior decision of the Court of Appeals, the Court held that when the IRS served its levy on the State, Hasley did not have “a sufficient beneficial interest in the monies, due or to become due . . . under the contract to give [Hasley] a property right in them,” and that interest was eliminated by the State’s agreement with Kemper. Therefore, the Court held, the State should have advised the IRS it did not possess any of Hasley’s property and was not otherwise obligated to Hasley. Its surrender of the money despite these facts left the State liable to Kemper for the difference between what the State turned over to the IRS and the amount Kemper recovered in federal court.

Owners who have contracted for the improvement of real property should be mindful of this ruling before responding to levies or garnishments against a contractor. Under Article 3-A, a contractor does not have title to amounts due or to become due under a contract for the improvement of real property until the claims of all laborers, subcontractors, design professionals, and/or materialmen are satisfied. Thus, amounts due under such a contract may not be properly paid to a creditor or taxing authority in regard to a contractor’s obligations. Subcontractors, materialmen, design professionals and others contributing to the completion of such a contract should also bear in mind that sums due under the contract do not belong to the prime contractor until their claims have been fully satisfied, and neither a tax levy nor any other garnishment or attachment can defeat their right to such payment. ■

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