

CORRECTING A FALSE STEP: RETHINKING OVERHEAD FOR THE
“ACTUAL EXPENSES” AFFIRMATIVE DEFENSE TO THE TEXAS
CONSTRUCTION TRUST FUND ACT

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The Texas Construction Trust Fund Act was enacted by the Texas Legislature in 1967 for the purpose of protection of subcontractors and materialmen and to ensure that they are paid for their labor and materials

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from funds paid to a contractor.¹ The Act creates a trust relationship, whereby the contractor is placed in the role of trustee of the funds paid, for the benefit of the subcontractors and materialmen, who are thereby treated as the trust beneficiaries.² The Act currently provides that a “trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds.”³ Such misapplication by the contractor/trustee constitutes a criminal offense,⁴ and has also generally been held to authorize a civil recovery against the contractor as well.⁵

The Act contains several affirmative defenses, one of which applies when “the trust funds not paid to the beneficiaries of the trust were used by the trustee to pay the trustee’s *actual expenses directly related* to the construction or repair of the improvement.”⁶ This affirmative defense is presumably present because the expenditure of monies directly related to the construction is seen as qualitatively different—and certainly less culpable than—the acts of an unscrupulous contractor in absconding with the trust funds for purely personal purposes or expenses to the detriment of his subcontractors and materialmen.⁷

However, since the 1987 amendment, some authorities have provided that a general contractor’s use of trust funds for general *overhead* would be sufficient to take advantage of this affirmative defense, and thereby avoid criminal and civil liability.⁸ This precedent of allowance for general overhead under the affirmative defense was brought to bear in the recent case of *In re Pledger*, where it was actually utilized to deny liability for a

¹ Act of May 29, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770, amended by Act of June 1, 1987, 70th Leg., R.S., ch. 578, § 4, 1987 Tex. Gen. Laws 2283; *Direct Value, L.L.C. v. Stock Bldg. Supply, L.L.C.*, 388 S.W.3d 386, 391 (Tex. App.—Amarillo 2012, no pet.).

² See TEX. PROP. CODE ANN. §§ 162.001, 162.002, 162.003 (West 2014).

³ *Id.* § 162.031(a).

⁴ *Id.* § 162.032. The offense is a Class A misdemeanor if basic misapplication of funds of \$500 or more is committed. *Id.* § 162.032(a). It is a third-degree felony if the misapplication is committed with intent to defraud. *Id.* § 162.032(b).

⁵ *Dealers Elec. Supply Co. v. Scoggins Constr. Co.*, 292 S.W.3d 650, 657 (Tex. 2009) (citing *C & G, Inc. v. Jones*, 165 S.W.3d 450, 453 (Tex. App.—Dallas 2005, pet. denied)).

⁶ TEX. PROP. CODE ANN. § 162.031(b) (emphasis added).

⁷ *Dealers Elec.*, 292 S.W.3d at 659.

⁸ See *infra* notes 82–91 and accompanying text.

contractor who had used trust funds on his own general business overhead.⁹ In following existing precedent, the bankruptcy court in *Pledger* stated: “*This interpretation of the statute is troubling to the Court. . . . Under such a standard it becomes difficult to determine what constitutes a violation of the statute. Indeed, under this approach, the affirmative defense appears to swallow the statute itself.*”¹⁰ The problem, of course, is that all general contractors will nearly always have substantial overhead, and if allowed to spend trust funds on such overhead without liability, the trust protection for subcontractors and materialmen afforded by the Trust Fund Act will have almost zero effect.¹¹ Nevertheless, the court in *Pledger* felt constrained to follow the apparent existing precedent allowing overhead expenditures to suffice for the “directly related” affirmative defense.¹²

The bankruptcy court in *Pledger* was right to be troubled. Applying the “direct expenses” affirmative defense to obtain this result is contrary to the spirit of the Trust Fund Act, its actual text, and its purposes. It results from a nearly nonsensical interpretation of the text of the current statute, and in so doing does great harm to the very parties—subcontractors and materialmen—that it is primarily designed to protect. And, it almost certainly is a misinterpretation of the original intent of the current form of the statute, as amended in 1987.

In fact, a review of the history of the Trust Fund Act—and, specifically, the “direct expenses” defense—will, the author believes, reveal that overhead expenses were not contemplated to be allowed to suffice for satisfaction of the affirmative defense under the present statute. That there is now precedent for such a result is a consequence of a series of misunderstandings in the cases, the legislative history, and apparent political pressure. This article seeks to rectify the misunderstanding and incorrect precedent and clarify that overhead expenses should not be sufficient to satisfy the affirmative defense. When the history of the statute is fully revealed—along with the concomitant legislative history—the error of the precedent for overhead allowance should be apparent. Further, even absent any misunderstanding, to allow overhead is contrary to the policy

⁹ See No. 12–6005–CAG, 2013 WL 796626, *5 (Bankr. W.D. Tex. 2013), *aff’d*, 2015 WL 294829 (5th Cir. 2015). The case was actually decided in a bankruptcy context, and the issue before the bankruptcy court was the dischargeability of the contractor’s debt under § 523 of the Bankruptcy Code. *Id.* at *1.

¹⁰ *Id.* at *7 (emphasis added).

¹¹ See *id.*

¹² See *id.*

behind the Trust Fund Act, and contractors should not be allowed to evade liability by spending trust funds on general overhead before first paying all beneficiaries with the contract funds with which they have been entrusted.

Part I of this Article will discuss the origins of the Trust Fund Act, including the draft versions leading up to its original enactment in 1967, as well as cases decided under this original version of the Act. Part II will discuss the 1987 amendments to the Act, as well as an oft-cited 1988 Attorney General Opinion issued shortly after the amendments; this part will also discuss the cases decided since the 1987 amendments. Part III will illustrate the error that has resulted in interpreting the affirmative defense, based on the plain meaning, the full legislative history, and the policy reasons for the statute. Part IV will present a conclusion.

I. THE 1967 ORIGINAL ENACTMENT OF THE TRUST FUND ACT, ITS LEGISLATIVE HISTORY, AND CASES DECIDED THEREUNDER

A. *The Enactment of the Trust Fund Act and Its History*

The original enactment of the Construction Trust Fund Act occurred in 1967, during the 60th Regular Session of the Texas Legislature.¹³ It was enacted by House Bill 42, and stated in its introduction that it was an Act “declaring construction payments and loan receipts to be trust funds; [and] defining wrongful disbursement and misapplication of trust funds as a misdemeanor and attaching a penalty.”¹⁴ The available legislative materials indicate that the need for the new law was that “[u]nder present law, there is no guarantee that funds paid to a contractor under a construction contract for the improvement of specific real property will be used only for the said construction project.”¹⁵

In order to accomplish this end, Section 1 of House Bill 42 originally defined construction trust funds as follows:

¹³ Act of May 29, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770, *amended by* Act of June 1, 1987, 70th Leg., R.S., ch. 578, § 4, 1987 Tex. Gen. Laws 2283.

¹⁴ *Id.* (original bill). The bill’s author was Joshua M. “Red” Simpson, and its coauthors were Willis James Whatley, John Traeger, Thomas Hutcheson “Tom” Bass, III, and J. Hudson Moyer. *Id.*

¹⁵ House Comm. Substitute, Bill Analysis, Tex. H.B. 42, 60th Leg., R.S. (1967), *available at* http://www.lrl.state.tx.us/LASDOCS/60R/HB42/HB42_60R.pdf. The filing of traditional mechanics’ and materialmen’s laws is another potential avenue of recovery for such subcontractors, artisans and materialmen. *See* TEX. PROP. CODE ANN. § 53.021 (West 2014).

Section 1. CONSTRUCTION PAYMENTS AND LOAN RECEIPTS DECLARED TRUST FUNDS. All moneys or funds paid to a contractor or any officer, director or agent thereof, under a construction contract for the improvement of specific real property in this state, and all funds borrowed by a contractor, subcontractor, owner, or any officer, director or agent thereof, for the purpose of improving such real property which are secured in whole or in part by a lien on the specific property to be improved are hereby declared to be Trust Funds for the benefit of the artisans, laborers, mechanics, subcontractors or materialmen who may labor or furnish labor or material for the construction or repair of any house, building or improvement whatever upon such real property and the contractor, subcontractor, owner, or any officer, director or agent thereof, receiving such payments or funds, or having control or direction of same, is hereby made and constituted a Trustee of such funds so received or under his control or direction.¹⁶

Section 2 of the bill then defined the wrongful misapplication of such trust funds by the contractor or other recipient:

Sec. 2. WRONGFUL DISBURSEMENT, USE OR RETENTION OF TRUST FUNDS. Any Trustee, who shall, directly or indirectly, with intent to defraud, retain, use, disburse, misapply, or otherwise divert, any trust funds, or part thereof, as defined in Section 1 of this Act, without first fully paying and satisfying all obligations of the Trustee to all artisans, laborers, mechanics, subcontractors, or materialmen, incurred or to be incurred in connection with the construction and improvements, for which said funds were received, shall be deemed to have misapplied said Trust Funds. . . .¹⁷

It is noteworthy that, in the bill's original inception, there was no allowance for the Trustee's overhead expenses (or any other expenses, for that matter)

¹⁶ Act of May 29, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770, *amended by* Act of June 1, 1987, 70th Leg., R.S., ch. 578, § 4, 1987 Tex. Gen. Laws 2283.

¹⁷ *Id.*

to be paid from the Trust Funds—rather, the obligations owed to the “beneficiaries” (*i.e.*, subcontractors, artisans and materialmen) were absolutely required to be paid first before the Trustee could use the Trust Funds for any other purpose.¹⁸

This absolute protection, however, was short-lived. The bill was debated initially in the House Judiciary Committee, and the committee first proposed a change to the bill in the form of Committee Amendment No. 1, which amended Section 1, defining Trust Funds, in the following manner (changes/additions noted by underline or strikethrough):

COMMITTEE AMENDMENT NO. 1

Section 1. CONSTRUCTION PAYMENTS AND LOAN RECEIPTS DECLARED TRUST FUNDS. All moneys or funds paid to a contractor or subcontractor or any officer, director or agent thereof, under a construction contract for the improvement of specific real property in this state, and all funds borrowed by a contractor, subcontractor, owner, or any officer, director or agent thereof, for the purpose of improving such real property which are secured in whole or in part by a lien on the specific property to be improved are hereby declared to be Trust Funds for the benefit of the artisans, laborers, mechanics, contractors, subcontractors or materialmen who may labor or furnish labor or material for the construction or repair of any house, building or improvement whatever upon such real property; provided, however, that up to and no more than 20% of said monies paid to a contractor or subcontractor or borrowed by a contractor, subcontractor or owner may be used to pay reasonable overhead and operating expenses of said contractor, subcontractor or owner. ~~and the~~ The contractor, subcontractor, owner, or any officer, director or agent thereof, receiving such payments or funds, or having control or direction of same, is hereby made and constituted a Trustee of such funds so received or under his control or direction.¹⁹

¹⁸ *See id.*

¹⁹ Act of May 27, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770 (Committee Amendment No. 1) (emphasis added).

The primary impact of Committee Amendment No. 1 was to allow the Trustee (often the general contractor) to use up to 20% of the Trust Funds, not for the payment of direct obligations owed to laborers, subcontractors and other artisans, but rather for payment of the Trustee's general overhead or expenses.²⁰ As the legislative analysis materials indicate: "There [under this version of the bill] is a 20% allowable to be used for reasonable overhead and expenses of operating before the provisions of this act are to be brought to bear."²¹ This was a direct detriment to the beneficiaries of the Trust, and served only to benefit the Trustee—who was, most of the time, the general contractor.²² Legislative materials from the 1967 session are sparse, but almost certainly this change to the bill was the result of lobbying by the general contractor/builder industry.²³

The changes to the bill, however, did not stop there.²⁴ Before leaving the House Judiciary Committee, Section 1 of HB 42 was changed one more time, by a second committee amendment (changes/additions noted by underline or strikethrough):

COMMITTEE AMENDMENT NO. 2

Section 1. CONSTRUCTION PAYMENTS AND LOAN RECEIPTS DECLARED TRUST FUNDS. All moneys or funds paid to a contractor or subcontractor or any officer, director or agent thereof, under a construction contract for the improvement of specific real property in this state, and all funds borrowed by a contractor, subcontractor, owner, or any officer, director or agent thereof, for the purpose of improving such real property which are secured in whole or in part by a lien on the specific property to be improved are hereby declared to be Trust Funds for the benefit of the artisans, laborers, mechanics, contractors, subcontractors or materialmen who may labor or furnish labor or material for the construction or repair of any house, building or

²⁰ *See id.*

²¹ Analysis of Committee Substitute, H.R. 42, 1967 Sess. (Tex. 1967), http://www.lrl.state.tx.us/LASDOCS/60R/HB42/HB42_60R.pdf.

²² *See id.*

²³ The advocacy of such groups will be plain in reviewing the legislative history of the 1987 legislation. *See infra* Part III.B.

²⁴ *See* Act of May 27, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770 (Committee Amendment No. 2).

improvement whatever upon such real property; provided, however, that ~~up to and no more than 20% of said monies~~ moneys paid to a contractor or subcontractor or borrowed by a contractor, subcontractor or owner may be used to pay reasonable overhead ~~and operating expenses~~ of said contractor, subcontractor or owner, directly related to such construction contract. The contractor, subcontractor, owner, or any officer, director or agent thereof, receiving such payments or funds, or having control or direction of same, is hereby made and constituted a Trustee of such funds so received or under his control or direction.²⁵

There are no readily available indicators of the legislative intent of this subsequent amendment. However, it makes at least three changes to Section 1 of the Bill. First (and perhaps most importantly), it completely eliminated the 20% limitation on the Trustee's use of the Trust Funds to pay his own overhead rather than using it to pay the beneficiaries (for whom it was originally intended), such as subcontractors, laborers and artisans.²⁶ Under this amendment, Trustees were allowed to spend the *entirety* of the received Trust Funds for their *own* overhead expenses, rather than forward a single dime to the intended beneficiaries of such Trust—again, the subcontractors, laborers and artisans who performed work on the project.²⁷ Second, it eliminated the ability of the Trustee to spend the Trust Funds on “operating expenses,” but rather limited the allowance to “reasonable overhead.”²⁸ Third, it added a purported limitation (an odd one, as will be seen), that the overhead spent must be “directly related” to the construction contract at issue.²⁹

It is quite arguable that this final amendment to House Bill 42 did great damage to the original purposes behind the bill and eviscerated its effect in advancing the original policy. The original animating concern of the bill was to give protection to the subcontractors and laborers who relied on the contractor to pay them from the funds received from the owner (or loan or

²⁵ *Id.* (emphasis added).

²⁶ *See id.*

²⁷ *See id.*

²⁸ *Id.*

²⁹ *Id.*

other source).³⁰ By allowing the entirety of the Trust Funds to be used instead for the Trustee's own overhead, it became possible for the beneficiaries to actually receive nothing whatsoever from the Trust Funds.³¹ The other changes in the final amendment—that “operating expenses” could not be paid from Trust Funds, and that any expenditure could only be on overhead “directly related” to the construction contract at issue—have the feel of attempts at legislative compromise, but in reality make little sense in the overall context of the final bill as amended.³² For one thing, the disallowance of payment for “operating expenses” adds little, as a great proportion of the contractor's expenses qualify as “overhead” and are thus subsumed within the allowance of the provision.³³ Moreover, the additional requirement that the reasonable overhead paid from Trust Funds be “directly related” to the construction contract is puzzling. According to *Black's Law Dictionary*, “overhead” is defined as “business expenses (such as rent, utilities, or support-staff salaries) that cannot be allocated to a particular product or service; fixed or ordinary operating costs. Also termed *administrative expense*; *office expense*.”³⁴ Thus, the allowance of “overhead” (defined as not allocated to a particular contract or service) that is “*directly related*” to a particular contract, would appear to be largely self-contradictory.³⁵ Overhead, by definition, is generally *not* related to any one particular product or service.³⁶ Nevertheless, Section 1 of House Bill 42 did not change further from this final language, and it was enacted into law at the end of the session and became Texas law.³⁷ It would appear that the original bill, intended to provide great benefit and protection for the beneficiaries/subcontractors, was drastically altered to instead provide a large measure of protection and cover for the general contractor/builder industry.

³⁰ Act of May 29, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770, *amended by* Act of June 1, 1987, 70th Leg., R.S., ch. 578, § 4, 1987 Tex. Gen. Laws 2283.

³¹ *See* Act of May 27, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770 (Committee Amendment No. 2).

³² *See id.*

³³ *See id.*

³⁴ BLACK'S LAW DICTIONARY 1278 (10th ed. 2009).

³⁵ *See id.*

³⁶ *See id.*

³⁷ Act of May 27, 1967, 60th Leg., R.S., ch. 323, 1967 Tex. Gen. Laws 770 (amended 1987) (current version at TEX. PROP. CODE ANN. § 162.031 (West 2014)).

The Trust Fund Statute, as it came to be called, was first set forth in Article 5472e of the Texas Revised Civil Statutes.³⁸ Later, in 1983 as part of the general codification process of Texas law, it was re-organized as Chapter 162 of the newly-enacted Texas Property Code.³⁹ As nonsubstantively re-enacted, Section 162.001 contained the provisions defining construction payments as trust funds.⁴⁰ Section 162.002 provided the same definition of the Trustee of the trust funds.⁴¹ Section 162.003 provided the same basic definition of the beneficiaries of such trust funds—the statute still provided that a beneficiary was an “artist, laborer, mechanic, contractor, subcontractor, or materialman who labors or who furnishes labor or material” for the construction or repair of real property.⁴² At that time, Section 162.031 provided the misapplication rule and the “reasonable overhead” exception as follows:

(a) Except as provided by Subsection (b), a trustee who, with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds without first fully paying all obligations incurred by the trustee to the beneficiaries of the trust funds has misapplied the trust funds.

(b) A trustee may use trust funds to pay the trustee’s reasonable overhead expenses that are directly related to the construction or repair of the improvement.⁴³

B. Cases Decided Under the Original Trust Fund Act and Its “Reasonable Overhead” Exception

Early on, the cases dealing with the newly-enacted statute noted generally that it supplemented the existing mechanic’s lien statutes, and also that the statute should be broadly and liberally construed so as to accomplish its intended purposes—namely, the protection of the beneficiaries named in the statute so as to allow them to be paid to the

³⁸ *Id.*

³⁹ Act of May 24, 1983 68th Leg., R.S. ch 576, 1983 Tex. Gen. Laws 3477.

⁴⁰ TEX. PROP. CODE ANN. § 162.001 (West 2014).

⁴¹ *Id.* § 162.002.

⁴² *Id.* § 162.003.

⁴³ *Id.* § 162.031.

fullest extent possible.⁴⁴ Beyond this, however, not many significant decisions were reported that dealt in some way with the overhead exception until 1982 when the Northern District of Texas issued *North Texas Operating Engineers Health Benefit Fund v. Dixie Masonry, Inc.*⁴⁵

In *Dixie Masonry*, a dispute arose between an employee benefit fund and the officer of a contractor company which was contractually required to fund the employee benefit plan with a stipulated amount for each hour worked by the employees on various construction jobs.⁴⁶ There was no question that the company owed the employee benefit contributions—the litigated issue was the applicability of the trust fund statute to an individual officer of the company.⁴⁷ There were two specific construction jobs for which the company had failed to contribute to the benefit plan.⁴⁸ The company incurred a loss on each of them, and rather than paying the benefit contributions on behalf of the employees, it paid other expenses, including its “general administration expenses” which were not directly traceable to any particular project—in other words, general overhead.⁴⁹

The court noted, under the statutory exception, that the “central issue in this action is what constitutes ‘reasonable overhead . . . directly related to [a] construction contract.’”⁵⁰ The court further noted the following:

As used in the statute, “overhead” is a broad term. As generally understood in the field of accounting, overhead broadly includes the continuous expenses of a business, without regard to the outlay on a particular contract. . . . The principal dispute is over whether defendants have shown that the general administration expense is overhead *directly related* to each of the jobs [as required by the statute]

. . . .

⁴⁴For an early case, see *Owens v. Drywall & Acoustical Supply Corp.*, 325 F. Supp. 397, 400 (S.D. Tex. 1971) (citing TEX. REV. CIV. STAT. ANN. art. 5160 (West 1971) and art. 5452 et seq. (West 1958 & Supp.1970)).

⁴⁵544 F. Supp. 516 (N.D. Tex. 1982).

⁴⁶*Id.* at 517.

⁴⁷*Id.* The company involved, Dixie Masonry, admitted liability under the statute. *Id.*

⁴⁸*Id.* at 517–19.

⁴⁹*Id.* at 518.

⁵⁰*Id.* at 519.

The [plaintiffs'] argument rests [on the point] that there was insufficient evidence presented to show that the general administrative expenses claimed by Dixie Masonry were directly related to the specific construction contracts. Implicit in this argument is the contention that the *fixed costs* which are included in the general administrative expense *can never be directly related to a particular construction contract*.⁵¹

The court, however, ultimately rejected the plaintiff's arguments.⁵² The court—faced with reconciling the odd use by Article 5472e of the terms “overhead” (which usually means general costs not tied to a particular project) together with the “directly related” proviso (which is at odds with the idea of general overhead)—noted the well-known principle of statutory construction that “every word in a statute is presumed to have been used intentionally and in the sense in which it is commonly understood, and when a word has a settled meaning or legal significance, it is presumed to have been used in that sense.”⁵³ Thus, the court was determined to have the exception make sense if at all possible.

As a result, the court resolved the issue by giving a particular meaning to “directly related overhead” that reconciled the use of these two seemingly contradictory terms: “The expenses that cannot readily be traced to a particular project are nonetheless ‘directly related’ *if the job could not have been obtained or completed without them*.”⁵⁴ As to the general administrative expenses at issue, the court had already found that they included overhead in the purest sense—general “office” expenses necessary for running the business (*i.e.*, salaries and utilities expenses).⁵⁵ Presumably, therefore, the court decided that essentially *all* overhead was “directly related.”⁵⁶ In other words, without paying rent to have an office, or without paying the phone bill monthly, etc., the contractor could not continue in business and do the various projects, and therefore paying these general

⁵¹ *Id.* at 519 (emphasis added) (citing *Vitex Mfg. Corp. v. Caribtex Corp.*, 377 F.2d 795, 798 (3d Cir. 1967); BLACK'S LAW DICTIONARY 1257 (4th ed. 1951); THE RANDOM HOUSE DICTIONARY OF ENGLISH LANGUAGE 1027 (1969)).

⁵² *See id.* at 519–20.

⁵³ *Id.* at 520 (citing *Turullols v. San Felipe Country Club*, 458 S.W.2d 206, 209 (Tex. Civ. App.—San Antonio 1970, writ ref'd n.r.e.)).

⁵⁴ *Id.* (emphasis added).

⁵⁵ *Id.* at 518.

⁵⁶ *See id.* at 520.

overhead expenses was thus “directly related” (in a sense) to the specific projects.⁵⁷ Lest this be seen as an exaggeration of the court’s position, it later stated: “the Court has . . . determined that the ‘directly related’ requirement *does not mandate that the expenses necessarily be traceable to a particular project.*”⁵⁸ Indeed, in *Dixie Masonry* no such attempt to trace them was done—the general administrative expenses were allocated to the particular projects solely by a ratio consisting of the project billings divided by the total billings for the same period.⁵⁹ It appears the court sanctioned this method as satisfactory for the requirement that the overhead be “reasonable,” as the court stated “the requirement that payments for overhead be reasonable . . . acts as a limitation on overhead expenses allocated to a particular construction contract.”⁶⁰ The plaintiffs argued that such a methodology was inappropriate since it did not show a direct tie-in to the projects at issue, but as noted the court ruled that no such tracing need be shown.⁶¹ It is difficult to imagine what overhead expenses the court in *Dixie Masonry* would have decided—given its rationale—was not “directly related.”

The next significant case to deal with the “reasonable overhead” provision was a criminal case, *McElroy v. State*.⁶² *McElroy* involved a contractor who was convicted of misapplication of trust funds.⁶³ One of the issues involved was the applicability and nature of the reasonable overhead provision.⁶⁴ The court held that the provision was an exception, rather than a defense, and that the prosecutor thus bore the burden of disproving that the trust funds were spent on “reasonable overhead.”⁶⁵ The court accordingly reversed the conviction, citing *Dixie Masonry* and observing that “[t]he State did not prove that the appellant allocated his overhead expenses in an unreasonable manner.”⁶⁶ Of note was a concurring opinion,

⁵⁷ See *id.* at 518, 520.

⁵⁸ *Id.* at 520 (emphasis added).

⁵⁹ *Id.* at 518.

⁶⁰ *Id.* at 518–19.

⁶¹ *Id.* at 520.

⁶² 667 S.W.2d 856 (Tex. App.—Dallas 1984, pet. granted), *aff’d*, 720 S.W.2d 490, 495 (Tex. Crim. App. 1986).

⁶³ *Id.*

⁶⁴ *Id.* at 864.

⁶⁵ *Id.* at 864–65.

⁶⁶ *Id.* at 865 (citing *North Texas Operating Eng’rs v. Dixie Masonry*, 544 F. Supp. 516, 519–20 (N.D. Tex. 1982)).

which reversed the conviction on the alternative basis that the provision excepting “reasonable overhead directly related to such construction contract” was unconstitutionally vague because “it fails to delineate the extent to which payment can be made of ongoing business costs apart from particular overhead incurred on a given job.”⁶⁷ Of particular concern to the concurring justice was use of the adjective “reasonable”—the court was concerned the term was too uncertain for a criminal statute, and that, as a result, a trustee contractor “must guess as to what the statute means when it refers to ‘reasonable overhead . . . directly related’ to the contract.”⁶⁸ The justice further explained that “the statute is not drafted with sufficient clarity to enable an individual to understand exactly what conduct is proscribed and is so vague, indefinite, and uncertain as to be incapable of being understood.”⁶⁹ Although the majority did not agree that the provision was unconstitutionally vague, this possibility would later be cited as one of the reasons for amending the statute.⁷⁰

The last significant case to be decided before the 1987 amendments to the Act was *In re Boyle*.⁷¹ *Boyle* was a bankruptcy decision, in which the primary issue was the dischargeability in bankruptcy of the debts owed by a contractor to a supplier, specifically by way of argument that a misapplication of trust funds under the Texas Act constituted a breach or defalcation while acting in a fiduciary capacity, under Section 523(a)(4) of the Bankruptcy Code.⁷² The opinion ultimately concluded that a violation of the Trust Funds Act does not necessarily constitute a violation of Section 523(a)(4).⁷³ Moreover, the “reasonable overhead” provision of the Act was not discussed directly in the opinion. However, in discussing the requirements of the Act, the Court made some observations that would later be cited by subsequent Texas courts as authorization:

The statute contains no provision requiring the fund holder to segregate funds by source and project; it does not

⁶⁷ *Id.* at 868.

⁶⁸ *Id.* at 869.

⁶⁹ *Id.*

⁷⁰ See *infra* notes 85–88 and accompanying text.

⁷¹ 819 F.2d 583 (5th Cir. 1987).

⁷² *Id.* at 583. Section 523(a)(4) provides that a “discharge under [various sections] of this title does not discharge an individual debtor from any debt . . . for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny. . . .” *Id.* at 587 n.8 (citing 11 U.S.C. § 523(a)(4) (2012)).

⁷³ *Id.* at 592–93.

prohibit the commingling of funds; it does not bar use of funds provided for one project to pay bills incurred on another project if this is done without an “intent to defraud”; and it does not prohibit a fund holder from paying, without any fraudulent intent, creditors on one project with surplus funds left over from earlier work and then using the funds provided for that later project on still other work. In short, the statute does not create “red,” “blue,” and “yellow” dollars each of which can only be used for the “red,” “blue,” or “yellow” construction project.⁷⁴

Of course, the court was assuming in its hypothetical that the “intent to defraud” culpability was missing⁷⁵—if “red” dollars were spent on the “blue” project *with* intent to defraud while “red” creditors remained unpaid, the Act in its present form *would* have been violated.⁷⁶ Also notably, “intent to defraud” was not then defined in the Act.⁷⁷ And further, the Court is not discussing the “reasonable overhead” provision in its opinion, at all. These caveats should be borne in mind when looking at subsequent cases citing *Boyle*.

II. THE 1987 AMENDMENTS, ATTORNEY GENERAL OP. JM-945, AND CASES DECIDED THEREUNDER

In 1987, the 70th Texas Legislature passed several amendments to the Trust Fund Act, including specifically the provision providing for an exception for reasonable overhead expenditures.⁷⁸ Shortly afterward, an Attorney General Opinion was issued regarding the amendments, and thereafter cases following the Opinion were decided, most of which ultimately had the effect of reiterating the continuation of precedent for the allowance of general overhead.⁷⁹ And this, notwithstanding the very significant textual change to the Trust Fund Act.⁸⁰ A discussion of the amendments, the AG Opinion, and the cases construing them follows.

⁷⁴ *Id.* at 586.

⁷⁵ *Id.*

⁷⁶ Act of June 1, 1987, 70th Leg., R.S., ch. 578, 1987 Tex. Gen. Laws 2283.

⁷⁷ *Id.*

⁷⁸ Act of June 1, 1987, 70th Leg., R.S., ch. 578, 1987 Tex. Gen. Laws 2283.

⁷⁹ Tex. Att’y Gen. Op. No. JM-945 (1988).

⁸⁰ Act of June 1, 1987, 70th Leg., R.S., ch. 578, 1987 Tex. Gen. Laws 2283.

A. *The 1987 Amendments: Creation of the “Actual Expenses” Affirmative Defense*

House Bill 1160 was introduced into the Texas House of Representatives during the 1987 legislative session.⁸¹ It made several changes to Chapter 162 of the Property Code,⁸² but significantly for purposes of this article it dramatically modified the “reasonable overhead” provision, by amending Section 162.031 in part as follows (changes/additions noted by underline or strikethrough):

Sec.162.031. MISAPPLICATION OF TRUST FUNDS. (a) ~~A~~ ~~Except as provided by Subsection (b),~~ a trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, use, disburses, or otherwise diverts trust funds without first fully paying all current or past due obligations incurred by the trustee to the beneficiaries of the trust funds, has misapplied the trust funds.

(b) It is an affirmative defense to prosecution or other action brought under Subsection (a) that the trust funds not paid to the beneficiaries of the trust were used by the trustee to pay the trustee’s actual expenses directly related to the construction or repair of the improvement ~~A trustee may use trust funds to pay the trustee’s reasonable overhead expenses that are directly related to the construction or repair of the improvement.~~⁸³

⁸¹ *Id.*

⁸² The first version of the bill proposed to eliminate the “intent to defraud” requirement, but this was later abandoned, and instead a definition of “intent to defraud” was added, along with an expansion of possible culpabilities to include “intentional or knowing.” *Id.*

⁸³ *Id.* (emphasis added). The bill added definitions to two terms in Section 162.031(a). “Intent to defraud” was defined in the bill as follows: “A trustee acts with ‘intent to defraud’ when he retains, uses, disburses, or diverts trust funds with the intent to deprive the beneficiaries of the trust funds.” (to be provided in newly added Section 162.005(1)). “Current or past due obligations” was defined in the bill as follows:

‘Current or past due obligations’ are those incurred or owed by the trustee for labor or materials furnished in the direct prosecution of the work under the construction contract prior to the receipt of the trust funds and which are due and payable by the trustee no later than 30 days following receipt of the trust funds.

These amendments were apparently enacted in large part as a reaction to both the difficulty in prosecution of the statute, as well as the concern (raised in the concurrence in *McElroy v. State*) that the “reasonable overhead” provision may be unconstitutionally vague.⁸⁴ One way that the bill served to ease the burden of prosecution was to add two additional levels of culpability beyond the high level “intent to defraud”—to this was added the ability to show the misapplication was committed “intentionally” or even simply “knowingly.”⁸⁵

The other change to Section 162.031 which is significant for purposes of this article was the complete elimination of the former “reasonable overhead” exception and its re-codification as an “actual expenses” affirmative defense.⁸⁶ The enforcement import of recharacterizing the provision as an affirmative defense was to shift the burden of proof on the issue to the defense, rather than making the prosecution or plaintiff disprove the issue.⁸⁷

Beyond the *procedural* modification of recharacterizing the provision as an affirmative defense, however, the bill *substantively* deleted the phrase “reasonable overhead” from the statute altogether.⁸⁸ In its place, the bill provided that in order to prove the affirmative defense and thereby eliminate liability for misapplication of trust funds by paying anyone other

Id. (to be provided in newly added Section 162.005(2)). Moreover, in addition to the “actual expenses” affirmative defense set forth above, the bill added two more affirmative defenses to the statute. The first affirmative defense requires:

trust funds not paid to the beneficiaries of the trust . . . have been retained by the trustee, after notice to the beneficiary who has made a request for payment, as a result of the trustee’s reasonable belief that the beneficiary is not entitled to such funds or have been retained as authorized or required by Chapter.

Id. (to be provided in newly added Section 162.031(b)). Second, the bill provides:

[i]t is also an affirmative defense to prosecution or other action brought under Subsection (a) that the trustee paid the beneficiaries all trust funds which they are entitled to receive no later than 30 days following written notice to the trustee of the filing of a criminal complaint or other notice of a pending criminal investigation.

Id. (to be provided in newly added Section 162.031(c)).

⁸⁴House Comm. on Judicial Affairs, Bill Analysis, Tex. H.B. 1160, 70th Leg., R.S. (1987), available at http://www.lrl.state.tx.us/LASDOCS/70R/HB1160/HB1160_70R.pdf.

⁸⁵Act of June 1, 1987, 70th Leg., R.S., ch. 578, 1987 Tex. Gen. Laws 2283.

⁸⁶See TEX. PENAL CODE ANN. § 2.04 (West 2011).

⁸⁷See *id.*

⁸⁸Act of June 1, 1987, 70th Leg., R.S., ch. 578, 1987 Tex. Gen. Laws 2283.

than the beneficiaries, the trustee was required to show that it paid “the trustee’s *actual expenses directly related* to the construction or repair of the improvement.”⁸⁹ This, in fact, remains the current language of the statute to the present day.⁹⁰ With the overt deletion of “reasonable overhead,” and substitution of the phrase “actual expenses directly related,” one would have thought that the matter was clear—the former statute’s provision for excepting overhead expenditures from liability under the Act (and followed in cases like *Dixie Masonry*) was legislatively overruled, and henceforth the trustee would have to prove the trust funds were paid for direct, traceable expenses on or attributed to the job site itself in order to avail itself of the affirmative defense. But, it turns out, things were apparently not to be so simple.

B. Attorney General Opinion No. JM-945

Shortly after the enactment of House Bill 1160, Senator John Montford, Chair of the State Affairs Committee, forwarded a list of seven questions to then-Attorney General Jim Mattox, the subject of which was “Interpretation of 1987 amendments to chapter 162 of the Property Code regarding construction funds or trust funds.”⁹¹ On August 24, 1988, the Attorney General formally responded by issuing Opinion No. JM-945.⁹² In his introduction, Attorney General Mattox noted that House Bill 1160 “made various provisions for the protection of subcontractors and other beneficiaries of funds paid or held under construction contracts,” and that

Chapter 162, as amended by House Bill No. 1160, provides that construction payments or loan receipts held for the purpose of paying for improvements of real property, are “trust funds” which may not be used or diverted by the holder until those who have furnished labor or materials have been paid.⁹³

The second question (relevant for current purposes) asked by Senator Montford was: “Do ‘expenses directly related to the construction or repair of the improvement’ under Section 162.031(b), Property Code, include the

⁸⁹ *Id.* (emphasis added).

⁹⁰ TEX. PROP. CODE ANN. § 162.031(b) (West 2014).

⁹¹ Tex. Att’y Gen. Op. No. JM-945 (1988).

⁹² *Id.*

⁹³ *Id.*

trustee's *overhead* and other expenses which, *though not readily traceable to a particular job*, are necessary to obtaining or completing the job (e.g., office rent, employee salaries, workers' compensation insurance, liability insurance, communications bill, etc.)?"⁹⁴ It is quite notable that Senator Montford used the exact phrasing from the *Dixie Masonry* case, which had authorized general overhead under the prior version of the statute (which expressly mentioned overhead).⁹⁵ The question, phrased thusly, is certainly consistent with an attempt to secure an interpretation from the Attorney General which continued to favor builders and general contractors, at the expense of subcontractors, materialmen and laborers.

In responding, the AG Opinion first noted that the statute had previously provided explicitly for overhead, but that the newly-revised version of the statute no longer continued this language—instead using the phrase “actual expenses directly related. . . .”⁹⁶ The Opinion further reiterated that the animating concern behind the amendment was apparently prior difficulty in obtaining successful prosecutions under the statute.⁹⁷ Nevertheless, the Opinion emphasized that the phrase “directly related” had not changed with the revision, and cited the *Dixie Masonry* case for the proposition that “[t]he expenses that cannot readily be traced to a particular project are nonetheless ‘directly related’ if the job could not have been obtained or completed without them.”⁹⁸ In citing *Dixie Masonry*, a pre-amendment case, the Opinion made no effort to state why the change from “overhead” to “actual expenses” in the statute should not have made a difference.⁹⁹

The other basis for what would be the Attorney General's answer to the question was some discussion from the legislative debate regarding House Bill 1160:

Representative Robnett:

Do you intend that it is o.k. for a builder to pay his superintendent, secretary, computer, pick-up truck, office or any administrative expenses and other similar expenses related to the construction of a home out of these trust funds?

⁹⁴ *Id.* (emphasis added).

⁹⁵ 544 F. Supp. 516, 520 (N.D. Tex. 1982).

⁹⁶ Tex. Att'y Gen. Op. No. JM-945 (1988).

⁹⁷ *Id.*

⁹⁸ *Id.* (citing *Dixie Masonry*, 544 F. Supp. at 520).

⁹⁹ *Id.*

Representative Parker:

I think, yes, I certainly do and I [want to] direct your attention, Buzz -- I think it's important—to that 'directly related' now. I think there has to be a—maybe you might need to ask a 'but for' question. And 'but for' the construction would I need to spend this money. And if it's related to construction, I think it's exempted. I do not think it presents a problem.

. . . .

Mr. Johansen [Executive Vice President of Texas Association of Builders]:

[W]hen you have a multiplicity of loans and a multiplicity of houses under construction it's almost impossible to track that money through and to prove that X draw was paid on X house when you have other on-going expenses and overhead—overhead items that you need to pay.

Senator Parker:

[Builders got in trouble under the old law] because they refused to keep decent records . . . what is so difficult about [it]. It ought not to be that hard to figure out some proportion of your overhead—total overhead that goes to per day, per month, per man hour worked.¹⁰⁰

Based on the cited legislative debate excerpts, and also based on the citation of *Dixie Masonry* (a pre-1987 amendment case), the Attorney General responded to Senator Montford's second question as follows:

In light of the foregoing, we conclude, in response to your second question, that the words of section 162.031, 'actual expenses directly related to the construction or repair of the improvement,' *include overhead* and other expenses which, *though not readily traceable to a particular job*, are necessary to obtaining or completing the job, so long as the expenses are 'actual,' *i.e.*, have in fact been incurred.¹⁰¹

In other words, notwithstanding the significant changes to the statute by the overt deletion of the word "overhead" from the statute, the Attorney

¹⁰⁰*Id.*

¹⁰¹*Id.* (emphasis added).

General Opinion nevertheless opined that the exact same result obtained under the new version of the statute as under the old.¹⁰² Overhead could be paid from trust funds, even if not tied to any particular construction project—resulting in subcontractors and other beneficiaries not getting paid.¹⁰³ Under the Opinion, contractors were essentially treated no differently in this respect, than they had been under the pre-1987 version of the Act when overhead was explicitly authorized, to the potential detriment of subcontractors and other beneficiaries.¹⁰⁴

C. Cases Decided Under the 1987 Amendments and AG Opinion

Within four years after the issuance of AG Opinion No. JM-945, the U.S. Court of Appeals for the Fifth Circuit issued its opinion in *In re Nicholas*.¹⁰⁵ *Nicholas* involved the bankruptcy proceeding of an individual who owned a general contractor, and the objection to dischargeability of debts owed by the contractor to a plumbing subcontractor.¹⁰⁶ At issue was whether or not the contractor had violated the newly amended Property Code Section 162.031, and if so whether such violation was sufficient to trigger the dischargeability exception of section 523(a)(4) of the Bankruptcy Code.¹⁰⁷ The contractor argued that no violation of the Trust Fund Act occurred, because he had satisfied the “actual expenses directly related” affirmative defense—further, the expenditures on which this argument were based were clearly general overhead:

[W]hile the evidence was “rather sketchy on exactly what happened to the money that was received [by the contractor],” all of the money from the projects went into the operation of [the contractor’s] business. The [lower] court also found that there was no evidence that the funds received from the owners of the project were used for any purpose other than to pay bills of the corporation.¹⁰⁸

¹⁰² *See id.*

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ 956 F.2d 110 (5th Cir. 1992).

¹⁰⁶ *Id.* at 110–11.

¹⁰⁷ *Id.* at 111.

¹⁰⁸ *Id.*

The Fifth Circuit, affirming the decision that the contractor had not violated the Trust Fund Act by virtue of the overhead payments, noted that the 1987 version of the statute appeared to permit such payments, observing that the affirmative defense was “open-ended” and allowed payment of actual expenses to those other than beneficiaries.¹⁰⁹ In so doing, the Fifth Circuit cited and directly relied on Opinion No. JM-945, as well as *In re Boyle* (a pre-1987 Fifth Circuit opinion).¹¹⁰ Relying on these authorities, the Fifth Circuit affirmed the bankruptcy court’s conclusion that the contractor’s actions in paying general overhead satisfied the affirmative defense—by simply using these trust funds and paying them “into the operation of his business . . . [i.e., using it] to pay bills in the corporation” was sufficient to evade liability, even though the subcontractors remained unpaid.¹¹¹ Thus, the AG Opinion No. JM-945 (coupled with *Boyle*) was cited and relied on by the Fifth Circuit in construing the post-1987 amendments to section 162.031, and the die for establishing this as precedent had been further cast.¹¹²

Although *In re Nicholas* was a federal opinion deciding issues of state law, its conclusion was subsequently cited and adopted by a Texas Court of Appeals in *Lively v. Carpet Services, Inc.*¹¹³ In *Lively*, a subcontractor sued the sole shareholder and officer of a bankrupt general contractor, claiming that the officer had misapplied trust funds received from the owner by not paying the subcontractor the amount owed.¹¹⁴ The trial court granted summary judgment for the subcontractor under the Trust Fund Act.¹¹⁵ However, the Court of Appeals reversed the summary judgment and remanded for trial, based on finding that the officer had raised a fact issue on the affirmative defense—specifically, the officer’s summary judgment evidence provided that the trust funds had been spent on “actual expenses

¹⁰⁹*Id.* at 113.

¹¹⁰*Id.* (citing Tex. Att’y Gen. Op. No. JM-945 (1988); *In re Boyle*, 819 F.2d 583 (5th Cir. 1987)). It is true that the court relied on *Boyle* in large part because it was also directly relevant precedent to the federal question of the dischargeability of the debt under § 523(a)(4) of the Bankruptcy Code. However, *Nicholas* also seemed to rely on *Boyle* as precedent for construing the Texas statute as well: “What *Boyle* said still almost precisely describes the Texas statute: ‘. . . the statute does not create “red,” “blue,” and “yellow” dollars each of which can only be used for the “red,” “blue,” or “yellow” construction project.’” *Id.* (citing *Boyle*, 819 F.2d at 586).

¹¹¹*Nicholas*, 956 F.2d. at 114.

¹¹²*Id.* at 113.

¹¹³904 S.W.2d 868, 876 (Tex. App.—Houston [1st Dist.] 1995, writ denied).

¹¹⁴*Id.* at 870.

¹¹⁵*Id.*

directly related to the construction and *office overhead*”¹¹⁶ The *Lively* court, citing *Boyle, Nicholas*, and Op. No. JM-945, stated that this was sufficient to prove the affirmative defense:

Although neither party has cited any Texas cases, the Federal courts that have addressed this issue have concluded that the Act does not prohibit the use of construction trust funds for *overhead* and other “directly related” expenses. In an advisory opinion, the Texas Attorney General has concluded that the affirmative defense allows a contractor to pay funds out for *overhead* and other expenses, even if they are not readily traceable, as long as they were actually incurred.¹¹⁷

Lively therefore further relied on these cases, and the Attorney General Opinion, in agreeing that overhead remained sufficient under section 162.031(b).¹¹⁸ Subsequent cases over the next 15 years continued to cite these authorities for the same basic proposition that general overhead was sufficient to prove the affirmative defense, including as recently as 2013.¹¹⁹

¹¹⁶ *Id.* at 876 (emphasis added).

¹¹⁷ *Id.* (emphasis added) (citations omitted).

¹¹⁸ *See id.*

¹¹⁹ *See, e.g.,* *Holladay v. C.W. & A, Inc.*, 60 S.W.3d 243, 248 (Tex. App.—Corpus Christi 2001, pet. denied) (citing *Coburn Co. of Beaumont v. Nicholas (In re Nicholas)*, 956 F.2d 110, 113 (5th Cir.1992); *Boyle v. Abilene Lumber, Inc (In re Boyle)*, 819 F.2d 583, 586 (5th Cir. 1987); *Lively*, 904 S.W.2d at 875–76; Op. Tex. Att’y Gen. No. JM-945 (1988)) (“The law interpreting section 162.031(b) does not require such an explicit level of proof tying particular expenditures to the improvements at issue. Construction trust funds may be used for overhead and other ‘directly related’ expenses.”); *Taylor Pipeline Constr., Inc. v. Directional Rd. Boring, Inc.*, 438 F. Supp. 2d 696, 715 (E.D. Tex. 2006); *Swor v. Bartley Tex. Builders Hardware Inc.*, (*In re Swor*), 347 Fed. App’x 113, 117 (5th Cir. 2009) (trust funds may be spent on “general business overhead”) (citing *Boyle*, 819 F.2d at 592); *Ratliff Ready-Mix, L.P. v. Pledger (In re Pledger)*, Bankr. No. 11-61151-CAG, Adv. No. 12-6005-CAG, 2013 WL 796626, at *6 (Bankr. W.D. Tex. March 4, 2013), *aff’d*, 2015 WL 294829 (5th Cir. 2015) (citing *Nicholas*, 956 F.2d at 110; *Swor*, 347 Fed. App’x at 117).

Interestingly, the Texas Supreme Court issued an opinion recently that cited the general affirmative defense rule, but did not mention overhead specifically, but rather only more “direct” expenses:

[T]he Trust Fund Act provides an affirmative defense when the trust funds not paid to a laborer or materialman were used to pay the trustee’s “actual expenses directly related to the construction or repair of the improvement.” TEX. PROP. CODE § 162.031(b)

There have been, however, a few instances of cases questioning the allowance of general overhead to satisfy the defense. The earliest objection was registered in 1997 by Bankruptcy Judge Leif Clark in *In re Faulkner*.¹²⁰ In *Faulkner*, the alleged misapplication of trust funds occurred when the contractor made payments to a couple of owners of its business, ostensibly for commissions in lieu of salary; that is, “essentially for compensation to the owners of the business.”¹²¹ Judge Clark actually concluded that no misapplication occurred, but the primary basis of his decision was based on an apparent lack of wrongful intent because of some timing issues.¹²² However, in dicta at the end of the opinion, Judge Clark went on to address whether the payments would satisfy the affirmative defense under section 162.031(b).¹²³ After reiterating that “this statute is to be construed broadly to effectuate the remedial purpose for which it was enacted, which was to protect the presumably ‘exposed’ subcontractor or supplier,”¹²⁴ Judge Clark discussed the actual language of section 162.031(b):

We . . . note that in parsing the language of the statute itself, the Texas Legislature used adjectives such as “actual” and “direct,” and tied those adjectives to the “construction” or “repair” of the improvements in question, strongly indicating that, while payments to other suppliers, or to workers actually making the improvements, or to subcontractors working on the job might be sheltered, *more “indirect” payments, such as overhead to the contractor in question, or “profit” built into the job’s price, would not so qualify.* Because the question is a close one, however, we turn to legislative history before rendering a final decision.

(West 2014). Such expenses include payments to subcontractors for costs actually and directly tied to the improvement.

Dealers Elec. Sup. v. Scoggins Const. Co., 292 S.W.3d 650, 659 (Tex. 2009) (citing *Taylor Pipeline Constr.*, 438 F. Supp. 2d at 716; *Holladay*, 60 S.W.3d at 248; Tex. Att’y Gen. Op. No. JM-945 (1988)). It does not appear, however, that general overhead was at issue in the facts of the case.

¹²⁰213 B.R. 660 (Bankr. W.D. Tex. 1997).

¹²¹*Id.* at 668.

¹²²*Id.* at 667.

¹²³*Id.* at 667–69.

¹²⁴*Id.* at 668.

That history is tracked in Texas Attorney General Opinion JM-945.¹²⁵

After initially casting doubt on the propriety of allowing general overhead to satisfy the affirmative defense, Judge Clark cited the Attorney General Opinion, and the legislative history relied on by the Opinion.¹²⁶ He particularly emphasized Representative Parker's response to Representative Robnett's question about overhead, highlighting the portion of Parker's response which stated: "*And 'but for' the construction would I need to spend this money. And if it's related to construction, I think it's exempted.*"¹²⁷ After reciting this exchange, Judge Clark further stated:

While the exchange is not as clear as we might desire on the point now before the court, it seems at least to indicate that expenses would have to be parsed into those *directly incurred* for a specific job, although not necessarily requiring there to be a direct physical effect on the construction site—e.g., the cost of a part-time bookkeeper to monitor the progress of a particular job site—and those *non-attributable expenses incurred whether the office was working on one job or a hundred—e.g., the monthly expense of a telephone. Only the former expense appears to fall within the exception to misapplication of trust funds established by § 162.031(b).* This interpretation is supported by the Attorney General's concluding paragraph:

the words of section 162.031, "actual expenses directly related to the construction or repair of the improvement," include overhead and other expenses which, though not readily traceable to a particular job, are necessary to obtaining or completing the job, so long as the expenses are "actual," i.e., have in fact been incurred.¹²⁸

Judge Clark thus concluded that, if the issue were before the court, he would hold that the general commissions paid to the contractor's owners from trust funds would not be sufficient under the affirmative defense, as he

¹²⁵ *Id.* at 668 (emphasis added) (citation omitted).

¹²⁶ *Id.*

¹²⁷ *Id.* (emphasis in original) (citing Tex. Att'y Gen. Op. No. JM-945 (1988)).

¹²⁸ *Id.* (emphasis added) (citation omitted) (citing Tex. Att'y Gen. Op. No. JM-945 (1988)).

rejected the interpretation of section 162.031(b) (contrary to *Nicholas, Lively*, and the common interpretation of Op. No. JM-945) as allowing such “indirect” or “general” overhead or other non-attributable expenses.¹²⁹ In conclusion on this point, Judge Clark noted:

Were we, in fact, to read chapter 162 as the defendant suggests, there would be very little of a contractor’s expenses that would not be sheltered by § 162.031(b). The exception would quickly swallow the rule. All the money spent by a debtor in the construction business would become expenses that fall into the exception created by § 162.031(b). We simply do not believe that the Texas Legislature, in enacting § 162.031 ever intended to eviscerate the Texas Construction Trust Fund statute in this manner, and therefore reject the debtor’s proffered interpretation.¹³⁰

Judge Clark’s reasoning has been cited approvingly by at least one other bankruptcy court opinion for the proposition that “[t]he affirmative defense at Section 162.031(b) for ‘actual expenses directly related to the construction or repair of the improvement’ is limited to costs actually and directly tied to the improvement in question and does not include ‘indirect’ expenses, such as overhead to the contractor in question, or ‘profit’ built into the job’s price.¹³¹ Thus, Judge Clark’s opinion in *In re Faulkner* stands in opposition to the weight of other precedent following Op. JM-945, in holding that general overhead should not be allowed to prove the affirmative defense of section 162.031(b).¹³²

A 2013 bankruptcy court opinion, *In re Pledger*, brought the tension between these two lines of cases into sharp focus.¹³³ *Pledger* involved yet again a contractor who failed to pay a subcontractor with trust funds,¹³⁴ but to prove he had satisfied the affirmative defense the contractor asserted that

¹²⁹ *See id.* at 668–69.

¹³⁰ *Id.* at 669.

¹³¹ *LVR Carpet Center, Inc. v. Coley (In re Coley)*, 354 B.R. 798, 800 (Bankr. N.D. Tex. 2006) (citing *Faulkner*, 213 B.R. 660 (Bankr. W.D. Tex. 1997)).

¹³² *See Faulkner*, 213 B.R. at 669.

¹³³ *See generally* *Ratliff Ready-Mix, L.P. v. Pledger (In re Pledger)*, Bankr. No. 11-61151-CAG, Adv. No. 12-6005-CAG, 2013 WL 796626 (Bankr. W.D. Tex. 2013), *aff’d*, 2015 WL 294829 (5th Cir. 2015).

¹³⁴ *Id.* at *1.

he had used the trust funds to pay his company's general overhead or bills—specifically, “he used the funds to pay truck payments, telephone bills, and payroll [and admitted that] he did not use those payments on expenses related to [the particular] project, but spent them elsewhere in the corporation.”¹³⁵ The bankruptcy court initially had ruled in favor of the subcontractor that the trust funds had been misapplied (and the debt was thereby nondischargeable in bankruptcy).¹³⁶ However, on motion for rehearing, the court was presented with the *Nicholas* line of cases relying on the Attorney General Op. No. JM-945, and specifically the recent Fifth Circuit case following this line, *In re Swor*.¹³⁷ Specifically, the court acknowledged that *Swor* (like *Nicholas* and other cases before it) stated: “Nor must these funds be spent only on the project for which they were received—they may be spent on other projects or on expenses related to *general business overhead*.”¹³⁸ The *Pledger* court noted that the *Swor* opinion “cited *Boyle* as providing the guiding principle that general business overhead expenses were permissible under the Texas Construction Trust Fund Statute.”¹³⁹ Faced with clear Fifth Circuit precedent on the issue, the bankruptcy court in *Pledger* granted the motion for reconsideration,¹⁴⁰ ruling that the contractor's expenditures were sufficient to prove the affirmative defense under *Swor*, *Boyle* and other precedents.¹⁴¹ However, before concluding his opinion, the judge made the following observation about the precedent allowing general overhead to suffice:

This interpretation of the statute is troubling to the Court. The Court shares the same concerns the bankruptcy court shared in *Faulkner*. Under such a standard it becomes difficult to determine what constitutes a violation of the statute. *Indeed, under this approach, the affirmative defense appears to swallow the statute itself.* Further, it allows general contractors to pick and choose who they pay

¹³⁵ *Id.* at *5.

¹³⁶ *Id.* at *2. In so doing, the court followed *Faulkner* and also an apparently unpublished opinion out of the Western District of Texas, *Aguado Stone v. Wissen*, Cause No. A-07-CA-506-LY (W.D. Tex. Mar. 11, 2008). *Id.*

¹³⁷ *Id.* at *5 (citing *Swor v. Bartley Tex. Builders Hardware Inc. (In re Swor)*, 347 F. App'x 113, 116 (5th Cir. 2009)).

¹³⁸ *Id.* (emphasis added) (citing *Swor*, 347 F. App'x 113, 116 (5th Cir. 2009)).

¹³⁹ *Id.*

¹⁴⁰ *Id.* at *7.

¹⁴¹ *See id.* at *6.

prior to filing bankruptcy, going against the guiding principle that bankruptcy allows and [sic] orderly distribution of assets to creditors.¹⁴²

Therefore, the current state of the interpretation of section 162.031(b) is, at best, “unclear” in the words of *Pledger*,¹⁴³ and more realistically, appears settled (however incorrectly) that general business overhead is ultimately sufficient to prove entitlement to the affirmative defense and therefore to avoid liability for misapplication of trust funds under Chapter 162.

III. CORRECTING THE MISSTEP: RESTORING THE PROPER INTERPRETATION OF THE STATUTE FOR THE PROTECTION OF THE BENEFICIARIES

The state of the case law interpretation of the section 162.031(b) affirmative defense to allow a contractor to avoid liability for misapplication of trust funds by simply spending the money on its general overhead is a failure of the policy which should have been implemented by the original promulgation of the Trust Fund Act, and certainly by the 1987 amendments. There are three means of illustrating this failure and the errant nature of such result: (1) the plain meaning of the statutory provision itself; (2) a more comprehensive view of the legislative history of the 1987 amendments which casts a shadow on the influential 1988 Attorney General opinion which shaped the current case law interpretation; and (3) the policy concerns that the statute is supposed to embody.

A. *The Plain Meaning of Section 162.031(b)*

A standard canon of statutory construction is that the court should begin with the plain language of the provision at issue.¹⁴⁴ The plain language of Chapter 162 provides that the money received by the general contractor is considered “*trust funds*.”¹⁴⁵ His receipt of the money renders him a

¹⁴²*Id.* at *7 (emphasis added) (footnote omitted). The court noted, in fact, that “[s]uch [was] the case here. Defendant chose not to pay Plaintiff for the concrete provided because Plaintiff was ‘the big dog’ who, in Defendants’ judgment, could afford to carry the loss.” *Id.* n.1.

¹⁴³*Id.* at *5.

¹⁴⁴67 TEX. JUR. 3D *Statutes* § 90 (2012) (citing *Hernandez v. Ebrom*, 289 S.W.3d 316 (Tex. 2009); *United Services Auto. Ass’n v. Brite*, 215 S.W.3d 400 (Tex. 2007); *Hines v. State*, 75 S.W.3d 444 (Tex. Crim. App. 2002)).

¹⁴⁵TEX. PROP. CODE ANN. § 162.001 (West 2014).

“trustee”¹⁴⁶ of the funds for the benefit of his “beneficiaries”—the artisans, laborers, mechanics, contractors, subcontractors or materialmen who furnish labor and supplies on the project.¹⁴⁷ The statute further provides that “a trustee who, intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts *trust funds* without first fully paying all current or past due obligations incurred by the trustee to the *beneficiaries* of the trust funds, has *misapplied* the trust funds.”¹⁴⁸

The concept of a “trust” has a very distinct, clearly known meaning. According to *Black’s Law Dictionary* a “trust” is “the right . . . to the beneficial enjoyment of property to which another person holds the legal title; a property interest held by one person (the trustee) at the request of another (the settlor) for the benefit of a third party (the beneficiary).”¹⁴⁹ Here, in the trust comparison, the party paying the money (typically the owner contracting for the improvement) would be in the position of the settlor or grantor, entrusting the money to the contractor as trustee,¹⁵⁰ for the express purpose in part to be sure that the ultimate beneficiaries—the laborers and subcontractors hired by the contractor to carry out the work—enjoy the benefit of the funds (*i.e.*, are paid for their work).¹⁵¹ To state it more simply, the contractor/trustee is supposed to be sure the subcontractors get paid from the money before he does anything else with it.¹⁵² If the contractor does not, he has misapplied the funds and violated the trust.¹⁵³ The plain meaning of the *prima facie* provision thus prohibits the contractor from violating the trust by using the money (with the wrongful intent) for *any* reason—whether otherwise legitimate business expenses or the costs of an impromptu vacation to Tahiti—before the beneficiaries are first paid. A trustee is after all, a fiduciary that owes the highest duty to his beneficiaries.¹⁵⁴

¹⁴⁶ *Id.* § 162.002.

¹⁴⁷ *Id.* § 162.003.

¹⁴⁸ *Id.* § 162.031(a) (emphasis added).

¹⁴⁹ BLACK’S LAW DICTIONARY 1740 (10th ed. 2014).

¹⁵⁰ TEX. PROP. CODE ANN. § 162.002.

¹⁵¹ *Id.* § 162.003.

¹⁵² *See id.* § 162.031(a).

¹⁵³ *Id.*

¹⁵⁴ *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.) (“Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place.

The first affirmative defense of section 162.031(b) provides a safe harbor for the contractor/trustee.¹⁵⁵ It provides that “[i]t is an affirmative defense to prosecution or other action brought under Subsection (a) that the trust funds not paid to the beneficiaries of the trust were used by the trustee to pay the trustee’s *actual expenses directly related to the construction or repair of the improvement*.”¹⁵⁶ Thus, the expenses must be “actual”—obviously actually incurred in fact—and they must further be directly related to the project.¹⁵⁷ “Directly,” or the root form “direct,” in this sense means “stemming immediately from a source; or, characterized by close logical, causal, or consequential relationship.”¹⁵⁸ Further, the word “related” means “connected by reason of an established or discoverable relation.”¹⁵⁹ The plain meaning of this provision would exclude any expenses which are *not* directly related—*i.e.*, no relation or only an indirect relation to the project.¹⁶⁰ Therefore, expenses which have *no relation* would obviously include clearly inappropriate expenses such as gambling debts or vacation costs to Tahiti.¹⁶¹ These would have no relation to any project, and thus would clearly not be sufficient under the section 162.031(b) affirmative defense.¹⁶²

But the same problem exists under the affirmative defense with *indirectly related* expenses. And the problem with “overhead” is that by its very definition it is generally conceived of as *indirect* expenses.¹⁶³ Overhead is defined as “business expenses (such as rent, utilities, or support-staff salaries) that *cannot* be allocated [i.e., are *not* “directly related”] to a particular product or service; fixed or ordinary operating costs.”¹⁶⁴ “Also termed administrative expense; office expense.”¹⁶⁵ This comports with the definition used by at least one Texas court: “As generally

Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.”).

¹⁵⁵TEX. PROP. CODE ANN. § 162.031(b).

¹⁵⁶*Id.* (emphasis added).

¹⁵⁷*Id.*

¹⁵⁸MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 353 (11th ed. 2006).

¹⁵⁹*Id.* at 1050.

¹⁶⁰*See* TEX. PROP. CODE ANN. § 162.031(b).

¹⁶¹*See id.*

¹⁶²*Id.*

¹⁶³*See* BLACK’S LAW DICTIONARY 1278 (10th ed. 2014).

¹⁶⁴*Id.*

¹⁶⁵*Id.* (emphasis added).

understood in the field of accounting, overhead broadly includes the continuous expenses of a business, *without regard to the outlay on a particular contract.*¹⁶⁶ To take monthly rent as an example, say that a contractor has office rent for \$2,000/per month. If he has Job A in January, the monthly rent is simply not directly related. It may be true that the contractor cannot adequately run a business without sufficient office space, but the fact remains that the contractor had the overhead rent expense before Job A, he has it during Job A, and he will continue to have it after Job A. *Overhead is not directly related to any one construction project.*¹⁶⁷ Or, as Judge Clark put it in *Faulkner*, overhead is “expenses incurred whether the office was working on one job or a hundred”¹⁶⁸—again, it is simply not directly related to any one project.¹⁶⁹ It is also exceedingly noteworthy that the legislature knew how to use the term overhead and specify it expressly—indeed it had done so in the previous version of the statute.¹⁷⁰ But the term is absent in the current version of the statute and accordingly, the plain meaning of the provision excludes typical overhead.¹⁷¹ To conclude that “overhead” (i.e., *indirect* expenses by definition) is allowed in a provision that calls for “actual expenses *directly* related,” is arguably an absurd result—one which courts are supposed to avoid in the interpretation of statutes.¹⁷² The plain meaning suggests otherwise—that overhead does not qualify.

¹⁶⁶N. Tex. Operating Eng’rs Health Benefit Fund v. Dixie Masonry, Inc., 544 F. Supp. 516, 519 (N.D. Tex. 1982) (emphasis added).

¹⁶⁷See BLACK’S LAW DICTIONARY 1278 (10th ed. 2014).

¹⁶⁸Airtron, Inc. v. Faulkner (*In re Faulkner*), 213 B.R. 660, 668 (Bankr. W.D. Tex. 1997).

¹⁶⁹See *id.*

¹⁷⁰Act of June 18, 1987, 70th Leg., R.S., ch. 578, § 4, sec. 162.031, 1987 Tex. Gen. Laws 2283, 2283–84 (amended 1987) (current version at TEX. PROP. CODE ANN. § 162.031 (West 2014) (cited in Boyle v. Abilene Lumber, Inc. (*In re Boyle*), 819 F.2d 583, 586 (5th Cir. 1987)).

¹⁷¹See TEX PROP CODE ANN. § 162.031.

¹⁷²67 TEX. JUR. 3D *Statutes* § 124 (2012) (citations omitted) (“The court will never adopt a construction that will make a statute absurd or one that will lead to absurd conclusions or consequences if the language of the enactment is susceptible of any other meaning. Application of any rule of construction will not be made that, in the circumstances, will lead to absurdity. The reason for the rule is that the legislature is not to be credited with doing or intending a foolish thing or with requiring a futile, impossible, or useless thing to be done.”).

B. An Expanded Look at the Legislative History and Intent of the 1987 Amendments and the Probable Error of Attorney General Opinion JM-945

The current case law interpretation of section 162.031(b) as allowing general overhead to suffice has its genesis in a series of cases beginning with *In re Nicholas*, which, in turn, was largely based on the 1988 Attorney General Opinion JM-945.¹⁷³ Recall that Opinion JM-945 was the response to an inquiry from Senator John Montford about the appropriate interpretation of House Bill 1160 in the 70th Legislature in 1987,¹⁷⁴ and one of the questions specifically asked about the propriety of including essentially general overhead as allowable expenses to satisfy the affirmative defense.¹⁷⁵ The Attorney General answered affirmatively, and thereby provided the basis for the current line of cases holding the same.¹⁷⁶ In the opinion, the Attorney General not only cited and relied on a pre-1987 case, *Dixie Masonry* (which had been decided when the statute expressly specified overhead),¹⁷⁷ it also relied on some excerpts from the legislative debate of House Bill 1160.¹⁷⁸

The Attorney General was well-advised to consider the legislative debates and history concerning House 1160, of course:

When the meaning of a statute is in doubt, reference may be made to legislative journals and records in order to ascertain the history of the passage of the act, to clarify it, or to disclose the intention of the legislature. Executive messages to the legislative body, debates, and committee reports may be considered.¹⁷⁹

But the Opinion cited only two isolated excerpts, concluding that they supported the conclusion that the affirmative defense allowed general

¹⁷³ See *supra* Parts II.B & C.

¹⁷⁴ Tex. Att'y Gen. Op. No. JM-945 (1988).

¹⁷⁵ *Id.* (“Do ‘expenses directly related to the construction or repair of the improvement’ under Section 162.031(b), Property Code, include the trustee’s overhead and other expenses which, though not readily traceable to a particular job are necessary to obtaining or completing the job (e.g., office rent, employee salaries, workers’ compensation insurance, liability insurance, communications bill, etc.)?”).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

¹⁷⁸ *Id.*

¹⁷⁹ 67 TEX. JUR. 3D *Statutes* § 147 (2012) (citations omitted).

overhead within its safe harbor.¹⁸⁰ A more complete look at the history *not* cited by the Opinion, however, reveals that the weight and balance of the debate actually weighs *against* the conclusion that general overhead was contemplated as sufficient for the affirmative defense. And, if this is true, then the very Opinion which provided the foundation for the current case law interpretation of the statute is suspect, which of course renders the entire line of cases suspect as well.

The first exchange cited and relied upon by the Opinion is as follows:

Representative Robnett:

Do you intend that it is o.k. for a builder to pay his superintendent, secretary, computer, pickup truck, office or any administrative expenses and other similar expenses related to the construction of a home out of these trust funds?

Representative Parker:

I think, yes, I certainly do and I [want to] direct your attention, Buzz I think it's important to that 'directly related' now. I think there has to be a maybe you might need to ask a 'but for' question. And 'but for' the construction would I need to spend this money. And if it's related to construction, I think it's exempted. I do not think it presents a problem.¹⁸¹

This exchange has been quoted accurately by the AG Opinion.¹⁸² When listening to the actual audio recording, however, it would appear that Parker was hesitant when he began ("I think, yes. . ."), and then made an attempt to clarify with the "directly related" and "but for" discussion.¹⁸³ And, in fact, his answer is internally inconsistent when matched with Robnett's question—a computer or office expense clearly does *not* satisfy Parker's "but for" test, as discussed previously with the nature of overhead.¹⁸⁴ And thus, as Judge Leif Clark mentioned in *Faulkner*, "the exchange is not as

¹⁸⁰Tex. Att'y Gen. Op. No. JM-945 (1988).

¹⁸¹*Id.* (citing Debate on Tex. H.B. 1160 on the Floor of the House, 70th Leg., R.S. (May 30, 1967) (tapes available at Reference/Documents of the Texas State Library and Archives Commission).

¹⁸²Debate on Tex. H.B. 1160 on the Floor of the House, 70th Leg., R.S. (May 30, 1967) (tapes available at Reference/Documents of the Texas State Library and Archives Commission).

¹⁸³*Id.* (statement of Representative Robnett).

¹⁸⁴*See supra* notes 164–172 and accompanying text.

clear as we might desire on the point”¹⁸⁵ It could just as easily be construed, in its totality, as *against* the propriety of general overhead as *for* it (though admittedly if so Parker was inconsistent in his response).

Moreover, when the entirety of the course of legislative debate on House Bill 1160 is observed, what becomes clear is that, in fact, most of the parties seemed to understand that the bill was *removing* the former language allowing overhead, which had the effect of substantively removing overhead as an allowed expense for purposes of the affirmative defense.¹⁸⁶ The first discussion of House Bill 1160 on record occurred on April 1, 1987, in the House Judicial Affairs Committee.¹⁸⁷ At that meeting, Representative Parker laid out the bill, and then two groups testified in favor of the bill, and one group (representing primarily general contractors) testified against it.¹⁸⁸ Robert Bass, testifying in favor of the bill (on behalf of a group of lumber suppliers), noted that the bill “*eliminates the ‘reasonable overhead’ exception to prosecution.*”¹⁸⁹ Jim Sewell, representing a large contractors association and testifying in opposition to the bill, was not specific in his testimony but merely said that “there are many . . . points in this that we feel would do a great deal of harm to a large construction project.”¹⁹⁰ Finally, Parker concluded the meeting on April 1 by stating that he was not only looking out for the interests of subcontractors who did not get paid out of trust funds, but also for the interests of homeowners who might be called upon to “pay twice” if the trust funds were misapplied (i.e., pay the general contractor, and then be forced to pay the subcontractor who remained unpaid or face liens on his house when the contractor used the trust funds for other purposes).¹⁹¹

¹⁸⁵ *Airtron, Inc. v. Faulkner (In re Faulkner)*, 213 B.R. 660, 668 (Bankr. W.D. Tex. 1997) (referring to discussion cited in Tex. Att’y Gen. Op. No. JM-945 (1988)).

¹⁸⁶ *See infra* this section.

¹⁸⁷ *See* Tex. H. Judicial Affairs Comm. Minutes 4, 70th Leg., R.S. (Apr. 1, 1987).

¹⁸⁸ *Id.* The two people testifying in favor of the bill were Robert Bass (representing Lumbermen’s Association of Texas) and Dick Hargis (representing the Texas Rental Association). The person testifying against the bill was Jim Sewell (representing Associated General Contractors—Texas Building Branch).

¹⁸⁹ Meeting on Tex. H.B. 1160 in Tex. H. Judicial Affairs Comm., 70th Leg., R.S. (Apr. 1, 1987) (Tape 2, Side 1) (emphasis added).

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

The next record discussion on House Bill 1160 occurred on May 19, 1987, in the Senate Criminal Justice Committee.¹⁹² Senator Parker laid out the bill, and Bass again testified in favor of the bill on behalf of the lumber suppliers. This time, two contractors' groups testified against the bill—Texas Association of Builders (represented by Lyle Johansen) and Associated General Contractors—Texas Building Branch (represented by Howard Rose).¹⁹³ This is the meeting from which the AG Opinion derived its second excerpt as follows:

Mr. Johansen [Executive Vice President of Texas Association of Builders]:

[W]hen you have a multiplicity of loans and a multiplicity of houses under construction it's almost impossible to track that money through and to prove that X draw was paid on X house when you have other ongoing expenses and overhead items that you need to pay.

Senator Parker:

[Builders got in trouble under the old law] because they refused to keep decent records . . . what is so difficult about [it]. It ought not to be that hard to figure out some proportion of your overhead total overhead—total overhead that goes to per day, per month, per man hour worked.¹⁹⁴

The Attorney General cited this exchange as part of his support for the conclusion that the legislative intent of House Bill 1160 was clearly to allow for the payment of general overhead expenses to satisfy the affirmative defense codified at section 162.031(b).¹⁹⁵

¹⁹²Tex. S. Criminal Justice Comm. Minutes, 70th Leg., R.S. (May 19, 1987).

¹⁹³Meeting on Tex. H.B. 1160 in Tex. S. Criminal Justice Comm., 70th Leg., R.S. (May 19, 1987) (Tapes 2 and 3). The minutes additionally reflect the following persons who were present in support of the bill but provided no testimony: H.R. Daniel Guerra of Great Houston Lumber and Building Materials Dealers Association; Billy Crawford and George D. Jones of Foxworth-Galbraith Lumber Company; Tom Hanover Building Materials, Round Rock; A. George Natsis of Edna Lumber Company; Robert C. Sneed of Texas Land Title Association; and Dick Hargis of Texas Rental Association. Tex. S. Criminal Justice Comm. Minutes, 70th Leg., R.S. (May 19, 1987).

¹⁹⁴Tex. Att'y Gen. Op. No. JM-945 (1988) (citing Meeting on Tex. H.B. 1160 in Tex. S. Criminal Justice Comm., 70th Leg., R.S. (May 19, 1987)).

¹⁹⁵*Id.*

However, a more careful and revealing look into the dialogue that occurred in the Committee meeting on May 19 reveals a much different picture. After Senator Parker laid out the bill, Bass again testified in favor of it, and stated that “*it eliminates the reasonable overhead exception and in its place gives an affirmative defense . . . to a contractor . . . [where] he can apply the funds to his actual expenses directly related to the project . . .*”¹⁹⁶ Bass further noted that when the contractor does not do this and pay the subcontractors, “[e]veryone is harmed, everyone is damaged when it’s not done.”¹⁹⁷ Then, Johansen began testifying in opposition to the bill in his status as Vice President of the Texas Association of Builders:

Mr. Johansen [Executive Vice President of Texas Association of Builders]:

We oppose House Bill 1160 for the following reasons *the bill prohibits the builder from using the loan funds to pay reasonable overhead.* Overhead expenses that he has that are directly in proportion to his business. *Under the bill a knowing use of the trust funds to pay overhead expenses would become a misapplication for which the builder would be subjected to criminal penalties without the intent to defraud.* Overhead items might include such gray areas as architectural costs, company trucks, superintendents—

Chairman:

Lyle, let me ask a question because as I read the bill it’s an affirmative defense to prosecution for other action under the proposal if the trust funds were used to pay the direct overhead costs of the project contractor. Am I—have I misread it?

. . . .

Johansen:

It says actual expenses directly related— my copy. Perhaps I have a wrong copy of the legislation—

Chairman:

No, actual expenses directly related.

¹⁹⁶Meeting on Tex. H.B. 1160 in Tex. S. Criminal Justice Comm., 71st Leg., R.S. (May 19, 1987) (Audio Tapes 2 and 3 available from Texas State Library and Archives Commission) (emphasis added).

¹⁹⁷*Id.*

Johansen:

Well you could have indirect costs such as accounting fees, how about insurance, workers' comp insurance. That's an indirect cost. . . . You have other gray areas where you have legitimate examples of where a bill came due that is directly related to the business and those bills are paid with the draw—with a draw—

Chairman:

Well, they're directly related to the project, expenses directly related to the project.

Johansen:

Not all of it would be. If you had your workers' comp premium come up you couldn't directly tie all of that premium to the draw. . . .¹⁹⁸

As this exchange shows, there is no question what Johansen—a sophisticated officer of a powerful Texas contractors association—thought the revised statutory language of House Bill 1160 meant. He interpreted the “actual expenses directly related” language to unequivocally eliminate overhead as an allowable expense for the affirmative defense.¹⁹⁹ Moreover, the legislators did not appear to meaningfully disagree or challenge Johansen regarding his conclusion.

And Johansen was not alone in his interpretation that day. Later in the hearing, Howard Rose testified in his capacity as the attorney for the Texas Building Division of the Associated General Contractors.²⁰⁰ This exchange occurred:

Chairman:

Howard, all he [the contractor] has to do is pay his bills. If he pays his bills

Howard Rose [attorney for Texas Building Division—Associated General Contractors]:

Well, I can read the bill, and the bill says that it is an affirmative defense and I read that to mean that the contractor has to come in and prove that that *money went*

¹⁹⁸ *Id.* (emphasis added).

¹⁹⁹ *See id.*

²⁰⁰ *Id.*

into the job and if he doesn't prove that then he's guilty of a crime. . . .if [the contractor] goes to paying the President or the home office expense [i.e., *overhead*] he's got a real problem. . . .²⁰¹

Rose, like Johansen, clearly interpreted the affirmative language to exclude use of the trust funds to pay general overhead expenses, and again, the legislators did not meaningfully disagree with Rose's opinion, but rather spent the bulk of the time in trying to persuade him of the merits of the bill.

The next instance of a record of legislative debate on House Bill 1160 came on the floor of the Senate on May 25, 1987. This exchange occurred between Senators Anderson and Parker:

Anderson:

Senator, as I understand it, a part of the bone of contention between the two factions concerned a treatment of overhead whether it was directly or indirectly related.

Parker:

Yes.

Anderson:

Could you explain how your, your Floor Amendment takes care of that?

Parker:

Well, the, the amendment or the portion of the substitute that I intend to offer that takes care of that, it gives you an absolute defense if after you've notified that a complaint has been filed, if you then—you have 30 days then to go pay those bills and that is a complete defense without regard to where it went.

Anderson:

I see. And the, as you understand it, the, your Floor substitute takes the—if you will the—

²⁰¹*Id.* (emphasis added)

Parker:

Takes away the objection that the home builders had, yes sir. They've signed off on this. They worked with the ah—the suppliers and lumbermen on this particular language.²⁰²

This exchange corroborates that the overhead issue was a “bone of contention” between the builders and the likely suppliers and subcontractors, as already demonstrated by the previous exchanges that had occurred in committee hearings. Interestingly, Senator Parker responds that this issue had been resolved—not by any change to the “actual expenses directly related” affirmative defense of section 162.031(b), but by a different “fail safe” affirmative defense provision contained, apparently, in what became section 162.031(c) which is not related to the characterization of the expenses paid but rather provides the contractor an escape path if he pays all beneficiaries in full within 30 days of being sent notice of a criminal complaint.²⁰³ It also clearly shows that the builders/contractors were not happy with the language of section 162.031(b), which apparently remained interpreted as eliminating their ability to pay overhead and avail themselves of the “actual expenses directly related” affirmative defense.

Later in the Senate Floor debate on May 25 Senator Tejada and Senator Parker had this clarifying exchange:

Tejada:

Senator, just by way of trying to determine your intent on this substitute. Does the definition in the substitute of current and past due obligations mean that a contractor who receives a construction loan draw must pay out ah—only those bills which the work was done at the time? And *once those are, those obligations are taken care of then it can be moved over and paid for the, the overhead, the other overhead?*

²⁰² Debate on Tex. H.B. 1160 on the Floor of the Senate 70th Leg., R.S. (May 25, 1987).

²⁰³ See TEX. PROP. CODE ANN. § 162.031(c) (West 2014). (“It is also an affirmative defense to prosecution or other action brought under Subsection (a) that the trustee paid the beneficiaries all trust funds which they are entitled to receive no later than 30 days following written notice to the trustee of the filing of a criminal complaint or other notice of a pending criminal investigation.”).

Parker:
That's exactly the intent.²⁰⁴

This dialogue also confirms that the intent of the bill was to not allow payment of overhead to avoid liability, when money was still owed to beneficiaries—subcontractors or other laborers with whom the general contractor had contracted. The beneficiaries are supposed to be paid first.

The final point at which a record of legislative debate exists regarding House Bill 1160 is the final House Floor debate which occurred on May 30, 1987, just as the legislative session was drawing to a close. This is the debate from which the Attorney General drew the previously discussed exchange between Representatives Robnett and Parker.²⁰⁵ After the Robnett question and answer, Representative Heflin asked some questions of Representative Parker, resulting in part in this exchange:

Heflin:
Uh, do you assume that he [the general contractor building a house] has included in the cost a profit for doing business, a profit for his part of the work?

Parker:
I think you have to assume that, yes.

Heflin:
Ok. Then, would it hamper him, or preclude him, from taking that portion that would be deemed as a profit and covering other incidental expenses that might not necessarily be related to your project? Would it, in that sense, restrict that kind of activity?

Parker:
. . . . I assume if you pay your current or past due obligations, then I assume that, that you, *if the rest of it is profit I assume you can use that.*²⁰⁶

Just as the Senate exchange between Senators Parker and Tejada had done previously on May 25, this exchange also on May 30 in the House confirms

²⁰⁴Debate on Tex. H.B. 1160 on the Floor of the Senate, 70th Leg., R.S. (May 25, 1987) (emphasis added).

²⁰⁵See Tex. Att'y Gen. Op. No. JM-945 (1988) (citing Debate on Tex. H.B. 1160 on the Floor of the House, 70th Leg., R.S. (May 30, 1987)).

²⁰⁶Debate on Tex. H.B. 1160 on the Floor of the House, 70th Leg., R.S. (May 30, 1987).

that the intent of the bill was to not allow payment of overhead to avoid liability, when money was still owed to beneficiaries, but rather only once such obligations had been paid current. (Tellingly, after the formal discussion on the bill was ended, the tape apparently kept rolling as the members began to depart, and you can clearly hear a discussion where one of the legislators is talking to someone about the hostility toward the bill, stating: “. . . well, we had a bunch of builders out there having a fit. . . .”).²⁰⁷

The legislative excerpts discussed above give a much fuller picture than did the two isolated excerpts contained in Attorney General Opinion No. JM-945. Although the Opinion characterized the legislative debate as supportive of the bill’s interpretation as allowing general overhead to suffice for proof of the affirmative defense, in actuality the weight of the legislative debate suggests the opposite—that the bill, consonant with the plain meaning, was interpreted by nearly all of the discussing parties as eliminating the prior allowance of overhead in proof of satisfaction of the affirmative defense.²⁰⁸ The debate shows (and the builders were clearly unhappy with) the interpretation that the bill disallowed payment of overhead expenses until all obligations owed to beneficiaries had been satisfied.²⁰⁹ As such, the conclusion of the Attorney General in Op. JM-945 is deeply flawed in this matter, which also casts a great shadow on the prior cases relying on the AG Opinion for this proposition.²¹⁰

C. Overhead Expenditures from Trust Funds Contravene the Policies of the Trust Fund Statute

The final argument against allowing contractors to avoid liability by using trust funds on their general overhead is that it contravenes the very policies that the Trust Fund Statute is designed to advance. The statute was obviously designed to protect materialmen, laborers and subcontractors, who rely on being paid from funds given to the general contractor by the owner or other source.²¹¹ The law was designed to supplement and

²⁰⁷ *Id.*

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *See supra* Parts II.B & C.

²¹¹ *See* STERLING W. STEVES & BRENDA T. CUBBAGE, THE COMPLETE GUIDE TO MECHANIC’S AND MATERIALMAN’S LIEN LAWS OF TEXAS § 6.01 (4th ed. 2000) (citing *Direct Value, LLC v. Stock Bldg. Supply, LLC*, 388 S.W.3d 386, 391 (Tex. App.—Amarillo 2012, no

complement the mechanic's lien remedy that such laborers also can utilize as a last resort.²¹² However, these procedures are time-consuming, laborious and uncertain—making sure the subcontractors and laborers are paid in the first place is obviously a much more desirable result.

The purpose of the trust fund statute is to be sure these laborers are paid first from trust funds received. Section 162.031(a) expressly provides that the contractor/trustee in receipt of trust funds misapplies those funds when he “intentionally or knowingly or with intent to defraud, directly or indirectly retains, uses, disburses, or otherwise diverts trust funds *without first fully paying all current or past due obligations* incurred by the trustee to the beneficiaries of the trust funds.”²¹³ The beneficiaries are intended to be paid first – before the contractor pays any other bills—ensuring that their obligations are satisfied.²¹⁴ To allow the contractor/trustee to instead use the trust funds to pay its *own* bills, such as its general overhead, obviously is diametrically opposed to the underlying policy goal of the statute in seeing that the beneficiaries are paid first. And it is contrary to the notion of the contractor as a “trustee,” as set forth in the statute.²¹⁵ It is axiomatic that a trustee is, as a general matter, not supposed to engage in self-dealing but rather must act in the utmost fiduciary manner toward his beneficiaries.²¹⁶ To construe the section 162.031(b) affirmative defense so as to simply allow a contractor to pay all of his general overhead and operating expenses from the trust funds, simply eviscerates the underlying policy that the statute sought to implement. Judge Clark's admonition in *Faulkner* here bears repeating:

Were we, in fact, to read chapter 162 as the defendant suggests, there would be very little of a contractor's expenses that would not be sheltered by § 162.031(b). The exception would quickly swallow the rule. All the money

pet.); *McCoy v. Nelson Utils. Servs., Inc.*, 736 S.W.2d 160, 164 (Tex. Civ. App.—Tyler 1987, writ ref'd n.r.e.); *Am. Amicable Life Ins. Co. v. Jay's Air Conditioning & Heating, Inc.*, 535 S.W.2d 23, 26 (Tex. Civ. App.—Waco 1976, writ ref'd n.r.e.).

²¹² *See id.* (citing *Owens v. Drywall & Acoustical Supply Corp.*, 325 F. Supp. 397, 400 (S.D. Tex. 1971)). The mechanic's lien statutes are in Chapter 53 of the Texas Property Code.

²¹³ TEX. PROP. CODE ANN. § 162.031(a) (West 2014) (emphasis added).

²¹⁴ *See id.*

²¹⁵ *Id.* § 162.002 (“A contractor, subcontractor, or owner or an officer, director, or agent of a contractor, subcontractor, or owner, who receives trust funds or who has control or direction of trust funds, is a trustee of the trust funds.”).

²¹⁶ *See* 72 TEX. JUR. 3D *Trusts* § 68 (2013).

spent by a debtor in the construction business would become expenses that fall into the exception created by § 162.031(b). We simply do not believe that the Texas Legislature, in enacting § 162.031 ever intended to eviscerate the Texas Construction Trust Fund statute in this manner, and therefore reject the debtor's proffered interpretation.²¹⁷

And, as the judge in *Pledger* added recently with regard to allowing overhead expenses for the defense: “Indeed, under this approach, the affirmative defense appears to swallow the statute itself.”²¹⁸

There is, however, an additional, related, reason that allowing overhead contravenes the policy objectives of the Trust Fund Act—the “pay twice” problem faced by the owners. The primary policy objective of the statute, as discussed, is to ensure that the beneficiaries—the subcontractors, laborers and materialmen hired by the general contractor to perform the work—are paid from the trust funds. However, there is another party who is directly impacted if the beneficiaries are not paid from the trust funds—the owner. If the subcontractors are not paid by their contractor/trustee who hired them, the subcontractors will still be entitled to seek relief and payment from the ultimate owners—this will be under various theories, including assertion of mechanic's liens²¹⁹ or other theories such as *quantum meruit*.²²⁰ That is, the owners will have to “pay twice.”²²¹ The first time they pay is to the general

²¹⁷ *Airtron, Inc. v. Faulker (In re Faulkner)*, 213 B.R. 660, 669 (Bankr. W.D. Tex. 1997).

²¹⁸ *Ratliff Ready-Mix L.P. v. Pledger (In re Pledger)*, Bankr. No. 11-61151-CAG, Adv. No. 12-6005-CAG, 2013 WL 796626, at *7 (Bankr. W.D. Tex. 2013), *aff'd*, 2015 WL 294829 (5th Cir. 2015).

²¹⁹ See generally TEX. PROP. CODE ANN. §§ 53.001–.287 (West 2011 & Supp. 2014).

²²⁰ See STEVES AND CUBBAGE, *supra* note 211, § 1.03.

²²¹ Meeting on Tex. H.B. 1160 in Tex. S. Criminal Justice Comm., 71st Leg., R.S. (May 19, 1987) (Audio Tapes 2 and 3 available from Texas State Library and Archives Commission). When introducing House Bill 1160 in the meeting on May 19, 1987, Senator Parker stated:

We continue to run into problems, however, with civil and criminal enforcement of those who particularly in tough times get to robbing Peter to pay Paul and home owners or people who contract for construction of various things *end up having to pay for their construction twice*. They pay for it and then discover that either some of their funds have been misapplied. The subcontractors don't get paid or they get halfway through it and even though they've paid in advance for a substantial part of the construction the funds are gone.

Id. (emphasis added).

contractor with whom they have privity (and to which funds are given in trust in part to pay whatever subcontractors are in turn hired). The second time, though, the owner may be called upon to pay is when the subcontractors are not paid, the trust is breached, and the subcontractors assert rights against the owner directly.²²² This is also the harm targeted by the Trust Funds Act.²²³ And, unlike allowing an affirmative defense for “actual expenses directly related” to the owner’s construction project or improvement, allowing the contractor/trustee to use trust funds to pay general overhead does nothing to avoid the “double payment” problem facing the owner. As Robert Bass said in testifying for House Bill 1160 in 1987: “[e]veryone is harmed, everyone is damaged when it’s not done”²²⁴—including the owner. As such, the underlying policy goals of the Trust Fund Act are thereby frustrated when overhead is allowed to suffice under the section 162.031(b) affirmative defense.

IV. CONCLUSION

The Trust Fund Act’s purpose is to ensure that subcontractors and laborers hired by a general contractor are paid from the funds paid to the contractor by the owner—this is the overriding objective.²²⁵ As initially

²²²*Id.*; see also Meeting on Tex. H.B. 1160 in Tex. H. Judicial Affairs Comm., 71st Leg., R.S. (April 1, 1987) (Audio Tape 2, Side 1 available from Texas State Library and Archives Commission). Rep. Parker stated, in closing the discussion of House Bill 1160:

I think Mr. Bass is probably looking at this more from the standpoint of subcontractors, things of that nature. *I’m looking at it from the standpoint of homeowners.* So that they, too, do not get into the position of borrowing money to add on or construct, or whatever a home, in good faith. The contractor takes the money, and instead of spending the money on that home he diverts that money to some other project. And then whenever it’s, uh, the dust settles and smoke clears, well, there’s always people out there that still haven’t been paid.

Id. (emphasis added).

²²³In most residential construction cases, in fact, the Trust Fund Act states specifically that homeowners are also express beneficiaries of the trust funds, because of this double payment problem. TEX. PROP. CODE ANN. § 162.003(b) (West 2014). (“A property owner is a beneficiary of trust funds described by Section 162.001 in connection with a residential construction contract, including funds deposited into a construction account described by Section 162.006.”).

²²⁴Meeting on Tex. H.B. 1160 in Tex. S. Criminal Justice Comm., 71st Leg., R.S. (May 19, 1987) (Audio Tapes 2 and 3 available from Texas State Library and Archives Commission).

²²⁵Act of May 27, 1967, 60th Leg., R.S., ch. 323, 1960 Tex. Gen. Laws 770 (West); *Direct Value, L.L.C. v. Stock Bldg. Supply, L.L.C.*, 388 S.W.3d 386, 391 (Tex. App.—Amarillo 2012, no pet.).

introduced in 1967, there were no exceptions to the requirement to first pay such beneficiaries from the trust funds.²²⁶ Through inartful compromise, the final version of the statute passed in 1967 did allow an awkwardly worded “overhead” exception, albeit with the dissonant proviso that such overhead be directly related to the project.²²⁷ However, after problems with the statute in that form emerged in the cases, the Act was revised in 1987 to completely eliminate the reference to allowing overhead expenses—instead providing it was an affirmative defense if the contractor utilized the trust funds for “actual expenses directly related” to the construction or project at issue.²²⁸ At first glance, the change appeared obviously to change the statute so that liability could not be avoided by spending the trust funds on the contractor’s general overhead. However, because of Attorney General Opinion No. JM-945, which interpreted the statute to continue to allow general overhead under the defense, several federal and state cases relied on the Opinion and held overhead was allowed.²²⁹

This is a bad policy outcome. It is based on a misreading of the statute, and it should be remedied. The Attorney General’s opinion was based on a dubious reading of the legislative history and debate on House Bill 1160, and in fact it is much more likely that all legislators and parties involved took the meaning of the new affirmative defense to be exactly what a plain reading would indicate—that while formerly overhead in some fashion was arguably allowed under the pre-1987 version of the statute, it was being clearly eliminated and replaced with a provision requiring expenditures to be of “actual expenses directly related” to the construction—something that is completely at odds with the traditional definition of “overhead.”²³⁰ How or why the Attorney General came to the opposite conclusion is mere speculation, although there was no question that the lobbying and pressure against such an outcome on the part of the various builders associations was transparent and intense.²³¹ This calls into question the entire line of cases allowing overhead under section 162.031(b), since they were all based on the 1988 Attorney General opinion which almost certainly misread the legislative intent and plain meaning of House Bill 1160.

²²⁶ See *supra* notes 17–18 and accompanying text.

²²⁷ See *supra* notes 26–39 and accompanying text.

²²⁸ See *supra* notes 82–91 and accompanying text.

²²⁹ See *supra* notes 92–143 and accompanying text.

²³⁰ See *supra* Parts III.A & B.

²³¹ See *supra* Part III.B.

The way forward would be for the appropriate courts to disagree with, or overrule as appropriate, the case law allowing overhead. On the federal side, this would appear to require that the Fifth Circuit—in an appropriate case—simply overrule its prior holdings in the *Nicholas*, *Boyle*, and the *Swor* cases, and hold instead that overhead is no longer sufficient to prove entitlement to the section 162.031(b) affirmative defense. On the state side, the various courts of appeal could overrule prior holdings, or decide for the first time that overhead is not sufficient. Given that the Texas Supreme Court does not appear to have squarely ruled on the issue, a holding on their part would also fully resolve the issue since they are not bound by the prior *Erie* holdings of the 5th Circuit or other federal courts.²³²

Alternatively, the Texas Legislature could resolve the issue by careful and explicit legislative amendment. The current Texas statute does, in its current and properly interpreted form, obviously leave room for the possibility that the contractor/trustee can use the trust funds to possibly pay someone (including possibly the contractor itself) other than the express beneficiaries, so long as the expenses are actually incurred and directly related to the particular construction project.²³³ The legislature could greatly simplify the matter by legislatively removing this possibility. For instance, the Oklahoma counterpart to the Texas Trust Fund Act is different, in that it does not contemplate payment to *anyone* other than beneficiaries until they are paid.²³⁴ There is no exception—the contractor/trustee violates the Oklahoma version of the Act if it does not pay the beneficiaries first.²³⁵ The contractor may not pay its overhead, and may not pay other expenses—it must satisfy the trust obligation to be sure that its beneficiaries are paid before any other expenditures are allowed. Such a result would vindicate the policy goals of the Texas Trust Fund Act in a much more straightforward manner, and insure that the beneficiaries are paid for their work.

These steps should be taken to reorient the typical players in Texas construction projects, in order to give back to the subcontractors, laborers,

²³² See *Kihega v. State*, 392 S.W.3d 828, 833 (Tex. App.—Texarkana 2013, no pet.).

²³³ TEX. PROP. CODE ANN. § 162.031(b) (West 2014).

²³⁴ See 42 OKLA. STAT. ANN. tit. 42, § 153 (West 2014) (“The trust funds created under Section 152 of this title shall be applied to the payment of said valid lienable claims and no portion thereof shall be used for any other purpose until all lienable claims due and owing or to become due and owing shall have been paid.”) (cited in *Coburn Co. v. Nicholas (In re Nicholas)*, 956 F.2d 110, 113 (5th Cir. 1992)).

²³⁵ See *id.*

materialmen and artisans the protection, which was the basis for the original enactment of the Trust Fund Act in the first place. Subcontractors and other beneficiaries need this protection, as they generally are smaller operatives and often lack the bargaining power and sophistication of the larger builders and general contractors.²³⁶ Many thus lack the resources and wherewithal to pursue their remedies in the event the contractor does not pay them from the trust funds. Rectifying the misstep in the development of the Trust Fund Act and its interpretation will go a long way toward achieving justice and fair, prompt compensation for the subcontractors, laborers and materialmen who provide their services in the Lone Star State.

²³⁶See *Hernandez v. Big 4, Inc.*, 241 F. Supp. 2d 715, 720–21 (S.D. Tex. 2003) (“The Court is well aware of the real world lack of bargaining power between subcontractors and general contractors.”); Gilson S. Riecken, *The Duty to Defend Under Non-Insurance Indemnity Agreements: Crawford v. Weather Shield Manufacturing, Inc. and Its Troubling Consequences for Design Professionals*, 50 SANTA CLARA L. REV. 825, 854 (2010) (noting “the disparate bargaining power between most contractors and their subcontractors”).