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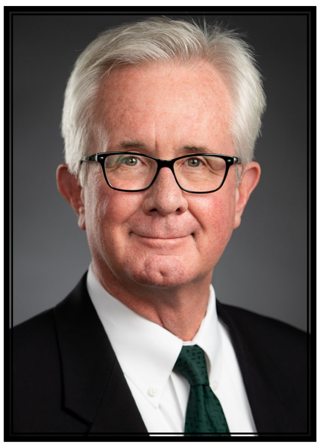
Bankruptcy Discharge of Debt When Debtor Violates the Colorado Construction Trust Fund Statue: The Evolving Law

Written By Steven Mulligan



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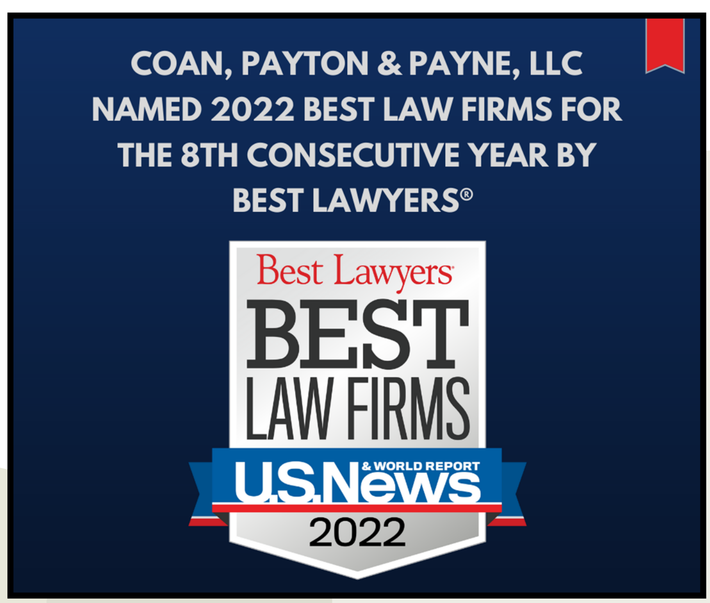
The Colorado Mechanic's Lien Trust Fund Statute (the "Trust Fund Statute"), provides that all funds disbursed to any contractor or subcontractor shall be held in trust for the payment of the subcontractors, laborer or material suppliers, or laborers who have furnished laborers, materials, services, or labor. C.R.S. § 38-22-127(1). A person who violates this statute is guilty of civil theft. C.R.S. § 38-22-127(5).

Contractors often find themselves in financial difficulties and use money paid to them on one project to cover costs for another project or for other purposes. As financial difficulties worsen, contractors cannot pay their subcontractors or material suppliers even though the contractor has been paid. The contractor's failure to pay is a violation of the Trust Fund Statute.

In the event the contractor files bankruptcy, an action can be brought to have the debt declared non-dischargeable under 11 U.S.C. § 523(a)(4) which excepts from discharge debts "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." To prevail, the plaintiff has to show that an express or technical trust exists, that the debtor owed a fiduciary duty arising from the trust, and that the debtor breached the duty by "defalcation" – that is, the debtor misused or misappropriated funds to be used to pay its subcontractors or material suppliers.

The Trust Fund Statute imposes a statutory trust so the technical trust and fiduciary elements necessary to prevail under § 523(a)(4) are met. The third element, defalcation, used to be met generally by showing that the plaintiff had unpaid invoices on construction projects on which the debtor had received funds meant for subcontractors, material suppliers, or laborers. *ASCI Readi-Mix & Asphalt Specialties, Co., Inc. v. Gamboa (In re Gamboa)*, 400 B.R. 784 (Bankr. D. Colo. 2008).

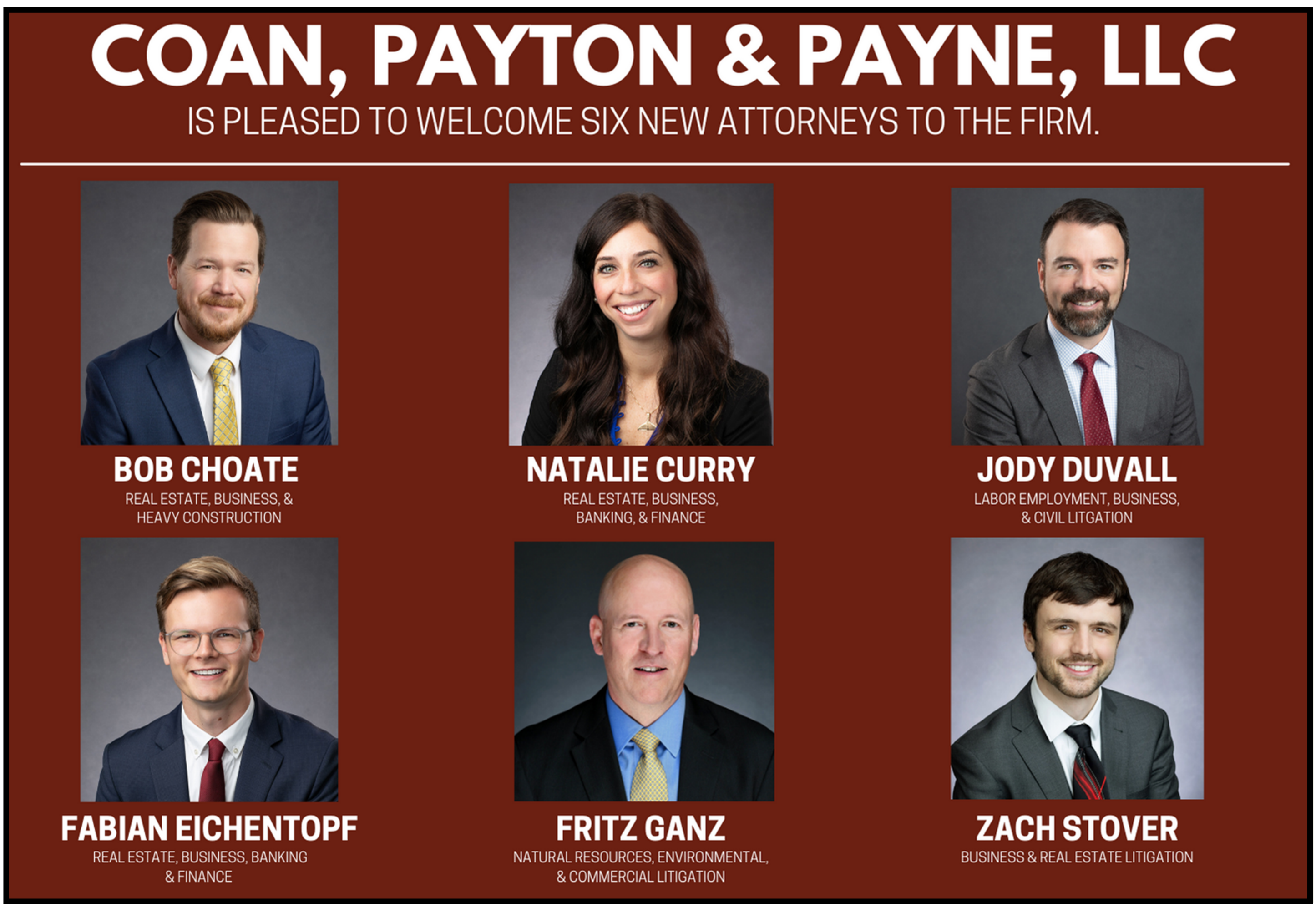
However, in 2013, the U.S. Supreme Court held that a plaintiff now had to prove that an "intentional wrong" was committed. *Bullock v BankChampaign, N.A.* 133 S. Ct. 1754 (2013). Following the Supreme Court's decision, the Bankruptcy Court in Colorado found that a debtor who did not know about the Trust Fund Statute could not have intentionally violated it. The court found, therefore, that



the debt was dischargeable. *MacArthur Company v. Cupit*, 514 B.R. 42 (Bankr. D. Colo. 2014). The *Cupit* court found that the lesser standard in *Gamboa* was abrogated by *Bullock*. In *MacArthur*, the debtor was using money received from one project to cover the costs of other projects believing that business would get better and he would be able to pay the debts of all projects. The debtor filed for bankruptcy protection. MacArthur sued to have its debt declared non-dischargeable because of the debtor's violation of the Trust Fund Statute. The debtor testified that he did not know about the Trust Fund Statute. As a result, applying the *Bullock* standard, the Bankruptcy Court found that the debtor did not knowingly violate the statute and therefore, the debt was dischargeable. Once the debtor became aware of the statute, any funds subsequently used in violation of the Trust Fund Statute were found to be non-dischargeable.

In 2020, the Colorado Bankruptcy Court again decided a case involving the violation of the Trust Fund Statute. *McGill v. McGill*, Nos. 2020 Bankr. LEXIS 3481 (Bankr. D. Colo. Dec. 7, 2020). In *McGill*, the court held that denial of having the requisite intent to violate the Trust Fund Statute, by itself, is not enough to answer the intent question because defendants rarely admit to having the required intent, and a debtor's intent can be inferred from the circumstances. The court found that the debtor's claims of ignorance rang hollow because the fiduciary duty imposed by Trust Fund Statute was clearly stated in the contract. A plaintiff need not prove that the defendant was aware of his or her duties under the Trust Fund Statute; instead, the question is whether the defendant's actions made it practically certain that the plaintiff would be deprived of the trust funds. *Gamboa*, *Cupit*, and *McGill* were all decided by the same bankruptcy judge.

The Colorado Court of Appeals weighed in on the effect of *Bullock* and *Cupit* in a case involving a violation of the Trust Fund Statute. *Franklin Drilling & Blasting Inc. v. Lawrence Constr. Co.*, 463 P.3d 883, 889 (Colo. App. 2018). The *Franklin* court followed the *Gamboa* court's analysis that the question is whether the debtor's actions made it practically certain that the plaintiff would be deprived of the use of trust funds. In a footnote, the



Franklin court noted that since it was faced with only state law issues, it could still follow the holding in *Gamboa* unlike the *Cupit* court which was bound by *Bullock*.

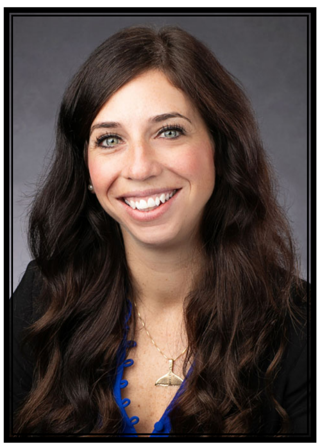
While having a debt declared non-dischargeable because of a violation of the Trust Fund Statute is not as easy as it was under *Gamboa*, it seems that *McGill* has made it a bit easier than it was under *Cupit*. And, at least for now, it seems that cases in State Court can still follow *Gamboa*.

G. Brent Coan named 2022 Best Lawyers® "Lawyer of the Year" in Corporate Law

Only a single lawyer in each practice area and designated metropolitan area is honored as the "Lawyer of the Year," making this accolade particularly significant. These lawyers are selected based on particularly impressive voting averages received during the peer review assessments.

House Bill 21-1121 and Senate Bill 21-173: Recent Changes to the Colorado Legislature Governing Real Estate Tenancies

Written by Natalie Curry



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The General Assembly of the State of Colorado (the "General Assembly") recently enacted House Bill 21-1121 (the "House Bill") and Senate Bill 21-173 (the "Senate Bill"), both of which became effective on October 1, 2021, and contain important changes to the laws governing real estate tenancies. This article provides a brief overview of some of those changes.

The House Bill

Rent Increase—Residential. The House Bill imposes additional obligations a landlord must adhere to when increasing a tenant's rent without a written rental agreement in place. Prior to this House Bill, a landlord was required to provide only twenty-one (21) days' notice to a residential or nonresidential tenant unless there was a written agreement between the parties stating otherwise. While that notice period still applies to *nonresidential* tenancies, the House Bill nearly triples the notice period for residential landlords by now requiring a minimum of sixty (60) days' notice to the tenant of any rental increase where there is no written agreement in place. It also preemptively prepared for some crafty landlords who may attempt to avoid this obligation by terminating a residential tenancy so that it can increase a tenant's rent without providing the required notice under C.R.S. § 38-12-701(2).

Additionally, the House Bill added two new sections that prevent a landlord of a mobile home park or a landlord of residential property from increasing the rent more than once in any twelve-month period of consecutive occupancy, regardless of the length of tenancy—fixed, indefinite, or otherwise—or whether there is a written agreement for the tenancy.

Evicting Tenants. Prior to the House Bill, once a landlord had obtained both a judgment from the court granting its request to evict a tenant, and an order directed to the county sheriff to oversee the removal of the tenant and its possessions from a premises—known as a writ of restitution—the county sheriff was able to immediately execute the writ. The General Assembly amended C.R.S. § 13-40-122(1) to now require a ten (10) day stay after the entry of the court's judgment during which a sheriff is prohibited from executing the Writ to evict a residential tenant.

The Senate Bill

Fees Assessed for Late Rent. The Senate Bill added a new C.R.S. § 38-12-105 that imposes additional obligations and prohibitions on residential landlords that apply when a residential tenant has failed to timely pay rent. Pursuant to a written agreement between the residential landlord and tenant, the landlord may only assess a late fee if rent is at least seven calendar days late.

Furthermore, a landlord may only assess a late fee of either $50 or five percent of the amount of the past due rent payment, whichever is greater, and the landlord is prohibited from charging any interest for the nonpayment of a late fee. Perhaps most importantly, however, if the rental agreement does not provide the right for the landlord to assess late fees, *then the landlord is prohibited from doing so*. Equally important, if the rental agreement contains any provision in violation of C.R.S. § 38-12-105, such provision is void and unenforceable. Moreover, the tenant may bring an action against the landlord, or any of its agents, who impose such a provision in violation of this section if the landlord or its agent does not cure the violation within seven days of the landlord receiving written or electronic notice of such violation.

Prohibited Provisions in a Rental Agreement. In addition to any provision that violates C.R.S. § 38-12-105, the Senate Bill added a new subsection (3) to C.R.S. § 38-12-801 that prohibits the inclusion of two specific clauses in a rental agreement. Section 38-12-801(3)(a) expressly prohibits an "unreasonable" liquidated damages clause that requires a party to pay such liquidated damages arising from an eviction notice or action. This bit of legalese means that a rental agreement may not assess a set fee (e.g. $25 per day) against a party who violates the terms of the rental agreement, leading to that party's eviction from the property. Section 38-12-801(3)(b) expressly prohibits a one-way clause that only awards attorney fees and court costs to one party. So, if a landlord wants the right to recover its attorney fees and court costs as the prevailing party in an action arising out of a written rental agreement, then it must be willing to accept the risk that it will be liable for the other party's attorney fees and court costs in the event it is not the prevailing party.

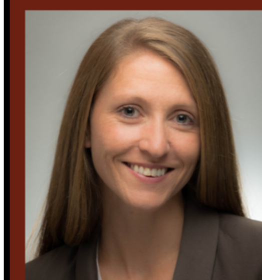
Conclusion

There are quite a few enactments and amendments by the House Bill and Senate Bill, and this article merely scratches the surface of those recent changes. It is always recommended that you have the *right* written rental agreement in place, and the assistance of an experienced team can help you navigate these frequent changes to the legislature and determine what is the "right" agreement for you.

Amanda Huston, John Seebohm, and Steven Mulligan Promoted to Partners

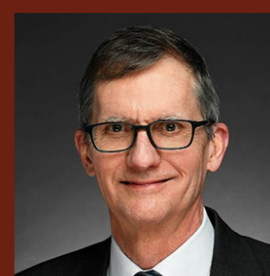
Coan, Payton & Payne, LLC promotes Amanda Huston, Steven Mulligan and John Seebohm to equity members.

Amanda Huston's legal practice focuses on corporate

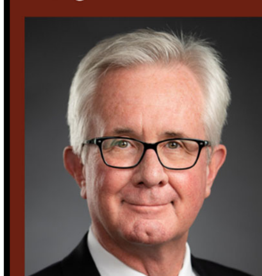


and real estate matters including: purchase and sale transactions; business organization; land planning and development; and commercial loan transactions.

John Seebohm's legal practice focuses on estate and business planning, estate administration and probate litigation. If disputes arise involving fiduciaries or beneficiaries in trust and estate matters, or among business owners, Mr. Seebohm has the ability to arrive at agreements to avoid litigation when possible, and to effectively, aggressively represent clients in court when litigation is unavoidable.



Steven Mulligan's practice focuses on business and commercial law, construction law, and bankruptcy and reorganization. Mr. Mulligan represents debtors,



creditors, construction contractors, businesses, business owners and sole proprietors. Mr. Mulligan also assists clients in receiverships, foreclosures, insolvency, and commercial litigation.