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CASE LAW ALERT!

I wish to bring to your attention a recent Appellate Division decision that has a significant impact on New Jersey's Construction Lien Law and, in particular, suppliers to the construction industry.

Prior case law has held that, under New Jersey's Construction Lien Law, a material supplier that seeks to file a construction lien has a duty to apply payments correctly against several open accounts of a material purchaser (e.g. subcontractors) if the supplier has reason to know that the monies came from a particular building project. Specifically, if a supplier knows that payments are being made by a subcontractor "on account", the supplier must apply those payments to a particular project if that payment came directly from a specific project. In the very recent case of L&W Supply Corporation v. DeSilva Contractors, et al. (December 19, 2012), the New Jersey Appellate Division considered what exactly is the obligation of a material supplier to "*ascertain the source of payments and to apply them accordingly*".

In L&W Supply Corporation, the supplier sold building materials to a now bankrupt subcontractor, Detail Contractors, Inc. Patock Construction was the general contractor for the project. L&W filed a lien claim against the project and its owners. The dispute was over the application of certain payments made and whether those payments were properly applied to the appropriate project since L&W had supplied materials to the subcontractor for various different projects. The Court's review of the lien included certifications of various bookkeepers and accounts personnel of the various entities involved in this dispute. The general contractor disputed how/whether certain payments were appropriately applied. It became obvious that a clear dispute existed as to how payments were allocated among the various projects. The Court determined that mere assertions that the payments were properly allocated without a demonstration of what affirmative steps the supplier took to assure that payments were properly applied were not sufficient under New Jersey's Lien Law.

The Appellate Division's ruling can be summarized as follows:

- Consistent with prior case law (Craft v. Stevenson Lumber Yard, Inc., 179 N.J. 56, 63 (2004), the Supreme Court ruled that without instructions to the contrary, a creditor (supplier) may apply payments from a debtor (subcontractor) in any manner it chooses.

- However, where the creditor knows or should know that a debtor is under an obligation to a third party to devote a relevant payment to discharge a duty the debtor owes to the third party, the payment must be applied properly regardless of the debtor's instructions or lack thereof.

- According to the Supreme Court's ruling in Craft, a supplier must allocate payments to the projects in which they knew were derived, if the supplier knows or should know the source of the payment.

- In this very recent Appellate Division case, the Court in L&W considered for the first time the circumstances that give a supplier "reason to know".

- **SIMPLY STATED**, the supplier must now inquire about the source of payments it receives. Failure to do so may warrant a finding that suppliers should have known the source of the payment. However, the Court held that the law should not generally require a supplier to challenge a purchaser's direction as to how to allocate payment or to suspect improper allocation of funds. *However, if the supplier has reason to suspect that something is wrong in the material purchaser's allocation of payments to different accounts, then case law requires that the supplier inquire further and verify the source of the payment funds.*

- For example, if a material purchaser seems to be using funds from one project to pay the older debts of other projects, a supplier should take further action to apply the payments correctly such as questioning the purchaser about the source of the payments or contacting prime or general contractors, and even owners, directly to ascertain the source of payment.

- The Court recognizes that this obligation does not always mean that a supplier must conduct an independent investigation of the source of payments. However, the supplier cannot, conversely, "*turn a blind eye to improper allocation of payments*".

- As a bottom line, in L&W, the Court held that when a purchaser of materials has not provided specific and reliable instructions as to the allocation of its payment, or when circumstances arise such that a reasonable supplier should suspect that the purchaser has not used an owner's funds to pay for material supplied for that owner, then the supplier must make further inquiry and attempt to ascertain the source of payment so they can properly allocate the money to the correct accounts.

This legal decision places a heavy burden upon suppliers and their internal accounts receivable personnel. It is imperative that certain protocols be put in place to ensure that a supplier's lien rights are properly protected consistent with the Appellate Division's decision discussed above.

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