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Understanding the Texas Supreme Court ruling regarding the McGregor Act bond

By Ben Aderholt

The Texas Supreme Court in July, in a ruling in *Dealers Electrical Supply Co. v. Scoggins Construction Co., Inc.*, confirmed the right of a construction subcontractor to bring a claim against a general contractor even though the sub has missed the strict notice requirements for a claim on a McGregor Act bond. Ben Aderholt of the Houston office of Looper Reed & McGraw represented Dealers Electrical Supply before the Supreme Court.

"This ruling is a great relief to suppliers from the Court of Appeals' holding," explains Ben Aderholt. "Subcontractors which are usually small businesses working on state or city construction projects now can be sure that, when they are not paid, they have recourse in addition to their claim on a McGregor Act payment bond, which is burdened with strict notice requirements."

If a subcontractor is not paid for work on a private construction project, he can file a lien on the property. But if the construction is on a public project for a unit of government, a bond is required and the subcontractor's usual recourse is to sue on the bond under the McGregor Act. A claim on a McGregor Act bond has stringent and complex notice requirements: if a notice is sent one day late, the subcontractor will have waived its right to the claim on the bond. Many subcontractors are small companies who are not represented by lawyers. By the time they realize they are not going to be paid, it may already be too late to file a claim on a bond provided under the McGregor Act. The objective of the strict notice requirement is to give the general contractor some notice that a subcontractor or its supplier has not been paid while the general is still holding construction funds during the project's construction. The Trust Fund Act, however, is designed to provide a remedy to an unpaid supplier after the project is completed and a supplier discovers the general has been paid but failed to pay its sub or its supplier.

Dealers Electrical Supply, an electrical parts supplier, filed suit against Diamond Industries, an electrical subcontractor, and against Scoggins Construction Company, the general contractor. It also sued the president and sole shareholder of Scoggins Construction. Dealers were not paid for electrical materials furnished to Diamond for use in the construction of an elementary school owned by the Mercedes Independent School District. The materials were supplied under a joint check agreement between Dealers, Diamond, and Scoggins. A joint check agreement is a credit facility frequently used to help a small subcontractor with low or unestablished credit to obtain supplies on credit from a supply house. That is to say, a general contractor agrees to issue a

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check to the subcontractor and its supplier jointly to pay for the materials furnished on credit for the job.

The *Dealers v. Scoggins* case was tried to a judge in Edinburg in April 2006. The trial judge agreed with Dealers that it could sue on the joint check agreement and under the Trust Fund Doctrine. (Found in Section 162 of the Texas Property Code.) The Trust Fund doctrine holds that, when a general contractor on a construction project receives funds from the owner, that money is earmarked for that job and is held in a trust for subcontractors and their suppliers. The general contractor has a fiduciary duty to use that trust fund to pay subcontractors and their suppliers as well as for direct overhead. When the owner pays the general contractor, but the general contractor fails to pay its subcontractors and their suppliers from those funds received (plus the direct overhead), then the subcontractors and their suppliers may hold the general contractor and its principals personally accountable for those funds. The Texas Legislature even toughened the standard in 1987. The Legislature amended the Trust Fund Act in response to some court opinions which allowed an officer of the general contractor to use trust funds to pay reasonable overhead expenses that were directly related to the construction. The 1987 Amendment only allows a trustee to use trust funds to pay actual expenses directly related to the construction. The trial judge awarded Dealers damages, attorney fees, and interest against Scoggins Construction and its president. Scoggins appealed to the Court of Appeals in Edinburg, which reversed the trial court on the notion that the McGregor Act bond claim was Dealers' exclusive remedy in the case.

The Texas Supreme Court granted Dealers' petition for review and reversed the Appeals' Court's holding. The Texas Supreme Court rejected the exclusivity theory upon which the Appellate Court founded its opinion. The Supreme Court reasoned that the Court of Appeals' holding was contrary to the text and the purpose of the McGregor Act and The Construction Trust Fund Act. The Texas Supreme Court held that the McGregor Act is not an exclusive remedy just because a payment bond was issued.

The good news for subcontractors and their suppliers is that, if they miss giving timely notice on a payment bond, there is another remedy available that may help them get paid for what they furnished to a public project. Moreover, those persons controlling the funds in the general contractor's office may be personally liable for a diversion of trust funds received from the owner. This is not new law, but it has never been confirmed so resolutely before and, this time it was announced by a unanimous Texas Supreme Court.

Because the Texas Supreme Court clearly stated that the payment bond was not a subcontractor's exclusive remedy, this allows subcontractors to negotiate joint check agreements with an owner and general contractor thereby creating ready and reliable credit by supply houses to subcontractors who have no other available credit facility. ■

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