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"A nonparticipating owner may provide notice to the contractors that the landlord is not involved in the construction and will not be responsible for payment."

Property Owner Protection from Tenant Mechanic's Liens

THIS ISSUE

Commercial property tenant improvements can be costly. In an economic environment where tenants may be financially uncertain, can property owners protect themselves from mechanic's liens relating to those tenant improvements?

BACKGROUND

We provide this brief factual scenario for context. A new commercial tenant wants to make tenant improvements, hires a landlord-approved contractor, and begins a substantial remodel to the rented premises. The contractor delivers a preliminary notice of the intended work to the owner, notifying the owner that the contractor may have the right to place a lien against the real property in the event he needs to recover for unpaid work. The project goes substantially over budget, and the tenant cannot, or will not, pay the contractor. The contractor records a mechanic's lien on title to the property, seeking to recover money from the building rather than the tenant. Meanwhile, the tenant becomes financially insolvent and cannot indemnify the owner. Can the owner protect itself from this lien?

IN BRIEF

A contractor who provides construction services for a work of improvement can normally look to the real property for payment in the event the contracting party fails to pay. The contractor must follow very strict guidelines in the mechanic's lien laws to do so, such as providing the owner advance notice of the possible lien, properly and timely recording the lien, and timely commencing an action or arbitration to foreclose the lien if it is not paid. Mechanic's lien law is founded in the California Constitution (and in the constitutions of many other states), and is intended to promote construction stability by ensuring that contractor's have a means of collecting for improvements they develop.

Thus the lien rights of contractors are well-established and well-protected, as long as they comply with the statutory guidelines.

A *nonparticipating owner*, however, may protect itself from liability for its tenants' construction projects by providing notice to the contractors pursuant to Civil Code section 3094 that the landlord is not involved in the construction and will not be responsible for payment. The 3094 notice is commonly referred to as a "Notice of Nonresponsibility." Like everything else in mechanic's lien law, it is statute-driven and fraught with peril for those who do not understand the nuances. And there are a great many nuances.

A nonparticipating landlord may, within 10 days of obtaining knowledge of the work of improvement, post a notice on site or in some other conspicuous place describing the property, and giving the owner's name and interest in the property, the name of the contracting party or lessee, and a statement that the landlord will not be responsible for any claims arising out of the project.

WHO IS A NONPARTICIPATING OWNER?

A landlord who is not involved in any way with the construction project is normally considered a "nonparticipating landlord." But in modern commercial leasing this is becoming less common. Frequently, commercial leases obligate a tenant to make tenant improvements to the property upon moving in, submit plans to the landlord for approval, and allow for landlord approval (or veto) of the contractor who will do the work. Often modern leases allow a tenant to be repaid out of the rental income for the improvements, and may even allow the landlord to make distributions of money to the contractor directly. If a court looking at the facts as a whole determines that a tenant is merely an agent for the landlord, then the landlord will be held to be a participating landlord, not entitled to the benefits of the Notice of Nonresponsibility.

WHEN MUST A NOTICE OF NONRESPONSIBILITY BE POSTED?

There is a very narrow window of opportunity for the owner to post a Notice of Nonresponsibility. The work must have actually commenced; thus, early notice is ineffectual. The notice must be posted in a conspicuous place within 10 days after the owner becomes actually aware of the commencement of work. The notice must also be recorded with the county recorder's office in that same 10-day period.

The owner does not have to post and record the notice until he has actual knowledge of the commencement of work. But as soon as he does know, the time period begins to run. Frequently, contractors will send the 20-day preliminary lien notice to owners by registered mail, thus establishing a date by which the owner must have known of the commencement of construction – or at the very least putting the owner on notice that he must investigate whether construction has begun on the premises.

Nevertheless, because it is so fact-driven, the date on which an owner learns of commencement of construction can be difficult to determine. While the owner can testify about when he first became aware, documents often show that a reasonably-prudent owner would have been aware much sooner, or perhaps even later. Since there is such a short time window to record and post a Notice of Nonresponsibility, contractors are often successful in invalidating those notices when the landlord did not act in a timely fashion. But at least one court has determined that the penalty for missing the 10-day window is simply too harsh for an owner who otherwise acts in good faith, and "seasonably" posts and records the Notice of Nonresponsibility upon learning of the commencement of construction. The "penalty" for an invalid notice, of course, is that it provides no protection against the contractor's lien.

PRECAUTIONS

Not every owner of property will want to record a Notice of Nonresponsibility. In the event the tenant has sufficient assets to insure against claims by the contractor, the owner may elect not to record a Notice of Nonresponsibility. A title insurance company that finds the Notice of Nonresponsibility during a title search may consider that to be a cloud on the owner's title and may exclude mechanic's liens from the title insurance. Thus, a prudent owner will want to consider these issues with an experienced attorneys' help before recording a Notice of Nonresponsibility.

WHY IS THIS IMPORTANT?

In times of economic uncertainty, property owners may be hit with multiple levels of financial difficulty. When a new tenant signs a lease, one of the incentives may be that the landlord will forego collection of rent for a period of months while the tenant performs tenant improvements to the building. If the tenant goes out of business without paying the contractor, then the landlord may lose the initial foregone rent, the cost of returning the premises to rentable condition for a different tenant, and, if the landlord is not protected against mechanic's liens, may even lose the cost of the original tenant improvements, as well as attorney fees and other court costs incurred in defending against the lien claim.

CONCLUSION

An owner who knows that a tenant is about to commence a construction project on the owner's land should ensure that he is kept informed of the exact start date of construction. He can thus ensure the posting and recording of the Notice of Nonresponsibility is both timely and proper. But if the owner becomes too involved in the project – such as controlling when the architectural design of the improvements, how they are financed, or what they will ultimately encompass – he risks being considered a participating owner, unprotected by Civil Code section 3094.

NEXT ISSUE

A Supreme Court ruling on enforcement of real property option agreements reverses a previously-reported appellate decision on this issue. (see REACH September 2007)

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