

HOW TO AVOID PAYING FOR TENANT IMPROVEMENTS TWICE!!

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You signed the lease with your new tenant after discounting the rent so that the tenant could afford to install its “awesome tenant-improvements.” Your tenant says that this new business is going to change the world!! The tenant installs those awesome improvements, but sadly doesn’t pay for them (once his investors decide not to change the world!). The inevitable mechanics liens are filed by the contractors, but you’re not concerned. After all, you posted your Notice of Non-responsibility, just like your lawyer told you to do. Will you have to pay for your tenant’s “awesome tenant improvements”? More than likely the answer is “yes.”

The preceding scenario is, unfortunately, based upon a true story. Many landlords and developers are under the impression that the posting of a statutory Notice of Non-responsibility makes them immune to mechanics’ liens created by tenants not paying for their tenants’ improvements. However, this assumption is almost always incorrect. Landlords and developers should be sure aware of the risks involved in relying on the Notice of Non-responsibility to protect them.

Under California Civil Code Section 8444, a Notice of Non-responsibility is defined as a written Notice, signed and verified by a person (or his agent) owning or claiming an interest in the site who has not caused the work of improvement to be performed, containing all the following: (a) a description of the site sufficient for identification, (b) the name and nature of the title or interest of the person giving the Notice, (c) the name of the purchaser under contract, if any, or a lessee, if known, and (d) a statement that the person giving the Notice will not be responsible for any claims arising from the work of improvement. This Notice must be posted within 10 days of knowledge by the person or entity claiming the benefit of Non-responsibility that construction has commenced. This Notice must be posted in a conspicuous place on the site, and must be recorded in the Office of the County Recorder in the county in which the property is located. If the owner/landlord fails to comply with the requirements of the statute, the Notice is rendered ineffective.

Unfortunately, simply posting the Notice may not be enough even if it does meet all the requirements. Under a legal doctrine known as the Participating Owner Doctrine, a Notice of Non-responsibility can also be found ineffective if the property owner causes the work of improvement to be performed. Pursuant to California law, contractors, subcontractors, laborers and materialmen have a right to record a mechanic's lien on real property upon which they have bestowed labor or furnished materials if the labor or materials were furnished "at the instance of the owner" or the owner's agent. In layman's terms, this means that if the terms of a lease between the owner/landlord and its tenant requires the tenant to construct improvements on the leased property, the work is deemed to have been done at the landlord's "instance". As a result, a mechanic's lien can be recorded and affect the owner's interest in the property, making the owner/landlord responsible for debts incurred by its tenant for the tenant's improvements.

The appellate court has extended the liability of the owner even further by ruling that: "For purposes of the Participating Owner Doctrine, the tenant need not act as the landlord's actual or ostensible agent; tenant becomes the agent of the landlord 'by implication of law' when the lease requires the tenant to make the improvements." The court went on to state that the fact that the lease did not require any particular improvements was not determinative. The court stated: "The question is whether the improvements were a practical necessity for the contemplated use of the premises." In short, if you enter into a lease with a tenant and the tenant is obligated to construct substantial improvements to the premises in order to meet the tenant's contemplated use as set forth in the lease, the owner will be subject to the participating owner exception and the owner's property may be subject to mechanics' liens.

Learn more about the use of a Notice of Non-responsibility at an in house seminar on November 15, 2017. The seminar will include a review of the recent changes in the law and how those changes can be applied to limit liabilities in Construction Contracts, Mechanics Liens, Notices of Non-responsibility, Bonds and Insurance Issues. Shareholders, Daniel Steinberg and Michael Middleton will discuss lease provisions that may assist owners and landlords in protecting themselves from liens when tenant.