

The Perils of Mechanics' Liens: How can a Landlord Avoid 'Getting Stuck with the Bill'?

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With the very public implosions of companies like Global Crossing, Enron, Exodus and Kmart, every landlord (and landlord's lender) is asking "Is there any way to protect myself from the possibility that a tenant—even one with stellar credit today—will fail to pay its contractors and leave me stuck with the bill?" Typically, leases with "good" tenants contained a prohibition on the establishment of liens created by the tenants, without, however, any requirement security for actual payment to the contractors. Unfortunately, what has been the recent trend is for many of these companies to watch their stocks plunge, and the companies, facing imminent bankruptcy, fail to pay the contractors for tenant improvement work. The contractors, realizing how fruitless it would be to try to get any money from bankrupt tenants, proceed to file various mechanics' lien claims against the landlords' fee interests. This article will address the following two issues: (i) are the mechanics' lien claims valid against the landlord's fee interest, and (ii) what can a landlord do to protect against this situation from occurring? Our focus is primarily on Illinois law. It is our understanding that many states have similar statutes and what is recommended for Illinois will have widespread application in other jurisdictions. A future article will look at the differences in other states' mechanics' lien laws.

Section 1 of the Illinois Mechanics Lien Act, 770 ILCS 60/0.01, et seq. (the "Act") provides in part as follows:

"Any person who shall by any contract or contracts, ...with the owner of a lot or tract of land, or with one whom the owner has authorized or knowingly permitted to contract, to improve the lot or tract of land...is known under this Act as a contractor, and has a lien upon the whole of such lot or tract of land..." Per the language of the Act, "*knowingly permitted*", the fee interest of an owner may become subject to a mechanic's lien claim if improvements are performed with the owner's knowledge and consent. The written consent of the owner is not necessary in order to prove that the owner "*knowingly permitted*" the construction of improvements. An owner may be deemed to have constructively consented if the facts and circumstances show that the owner was aware that the improvements were being made and failed to make an objection to the mechanic or materialman. "Illinois courts have held, in the context of a lessor-lessee relationship, that an owner's interest in property is subject to a lien for the labor and materials furnished by a third party where the owner authorizes a tenant to contract with another for repairs, or where the owner had notice that such repairs were being made upon the property and made no objection to them." *Leveyfilm, Inc. v. Cosmopolitan Bank & Trust*, 274 Ill.App.3d 348, 653 N.E.2d 875, 877, 210 Ill.Dec. 680 (1st Dist. 1995)

Further, even though the owner may have had no actual knowledge that the work was being performed, it is possible for consent to be implied. For example,

implied consent may be deemed if the premises are leased for a purpose and the owner knows that alterations or improvements will be necessary to use the property for that particular purpose. *Henderson v. Connelly*, 123 Ill. 98, 14 N.E. 1 (1887), *Loeff v. Meyer*, 284 Ill. 114, 119 N.E. 908 (1918). In the case of *Boyer v. Keller*, 258 Ill. 106, 101 N.E. 237 (1913), a landlord entered into a lease with a tenant whereby the lease provided that the premises were to be used only as a theater. At the time of execution of the lease, there was situated on the lot a wooden structure which had been used as a skating rink and it was wholly impractical to use the building as a theater without making extensive changes and repairs. The lease provided that the tenant could make such changes and repairs, but required the tenant to obtain the landlord's approval before commencing the work. The tenant, without obtaining the landlord's prior approval, contracted with a contractor to do the carpenter work necessary to make the building suitable for use as a theater. The tenant subsequently failed to pay for the work which had been done to the building and the contractor filed a lien claim against the landlord. The court held that "Where a building leased solely for a theater is wholly unfit for use for such purpose without extensive alterations, and the lease provides that the lessee may make alterations at his own expense...the matter of making such alterations must be regarded as the joint enterprise of the owner and lessee." Thus, under Illinois case law, it is not hard to prove that an owner "has authorized or knowingly permitted to contract" for tenant improvements. However, the lienor has one further hurdle to overcome.

As stated above, the Act provides a lien for payment to those who provide labor, material, fixtures, apparatus, machinery and other services specified in the Act in conjunction with the construction of improvements on real property. "The purpose of the Mechanic's Lien Act is to require a person with an interest in real property to pay for improvements or benefits which have been induced or encouraged by his or her own conduct." *Leveyfilm, Inc. v. Cosmopolitan Bank & Trust*, 274 Ill.App.3d 348, 653 N.E.2d 875, 877, 210 Ill.Dec. 680 (1st Dist. 1995). To create a valid lien, the performance or furnishing of materials must constitute an enhancement of the value of the property. "Thus, the focus of inquiry remains whether the work performed enhanced the value of the land to be charged with the lien." *D.M. Foley Co. v. North West Fed. Savings*, 122 Ill.App.3d 411, 415, 461 N.E.2d 500, 503 (1st Dist. 1984). In *Crowley Bros., Inc. v. Ward*, 322 Ill.App. 687, 54 N.E.2d 753 (1944), the court held that where a tenant leased property for a restaurant and had certain trade fixtures installed in the building, none of which was of any benefit to the building and which disappeared after tenant forfeited the lease, and there was no showing that such items were intended by the parties to become part of the premises, landlord's interest was not subject to mechanics' lien for labor and materials furnished. In *L.J. Keefe Company, Inc. v. Chicago and Northwestern Transportation Company*, 287 Ill.App.3d 119, 678 N.E.2d 41, 222 Ill.Dec. 634 (1st Dist. 1997), the court found that installations of steel casing and pipe grouting for the purpose of transmitting electric current across property was not lienable. Specifically, the court stated that the more efficient

transmission of electric current for power and communications that resulted from the installations was too attenuated to be a "benefit" to the landowner and that the work performed did not enhance the value of the land.

Having established that mechanics' lien claims can be valid against the landlord's fee interest, there are many things an owner can do to preempt the situation in which the contractor will not get paid for its work done for the tenant. First, an owner can require the establishment of a construction escrow to handle all disbursements of tenants' construction, and require that the escrow be fully funded before allowing any tenant to perform work in the building. Depending on the extent of the improvements, a landlord may require a tenant to deposit one hundred and ten percent, or more, of the estimate of the cost of the work. The construction escrow should require that each disbursement of the proceeds be subject to satisfaction of various conditions as of the time of such disbursement, including: (a) the owner's reasonable satisfaction that the work completed as of the date of disbursement has an aggregate value at least equal to the aggregate amount of proceeds then to be disbursed plus the total amount thereof previously disbursed; (b) receipt by the owner and the title insurer of sworn statements, waivers of lien and other documents and assurances required to protect the owner against mechanics' and other liens; and, (c) receipt of assurances satisfactory to the owner that the amount remaining on deposit in the escrow after such disbursement is adequate to complete the remaining work. The construction escrow should further require that any final disbursement from the escrow will also

be conditioned upon the tenant delivering the following to the owner: (a) an architect's certificate of final completion; (b) copies of all necessary governmental permits, including, but not limited to, a certificate of occupancy, if necessary; (c) the sworn statement of the general contractor; and (d) final lien waivers from all contractors, subcontractors and materialmen. However, it should be noted that if the tenant breaches the terms of the lease and/or the terms of the construction escrow, the owner's fee interest can still be subject to a lien claim if the contractor was not made aware of the provisions of the lease and/or escrow agreement. Therefore, to enable the owner to use funds deposited into the escrow to pay for any work that has been performed, and to avoid bankruptcy concerns, the escrow should be set up so that the tenant has no further interest in or control of the money, once it has been deposited into the escrow.

Second, an owner can post no-lien or non-responsibility notices in the states that allow an owner to do so (Illinois does not recognize this). A no-lien or non-responsibility notice is either recorded in the jurisdiction where the property is located or posted directly at the property, depending on the state. The notice specifically says that the owner of the property shall not be responsible for payments due under contracts between a contractor and a tenant of the property. Therefore, in the event that an owner posts a no-lien or non-responsibility notice, the owner will only be liable for amounts due under contracts between a contractor and the owner itself.

Third, an owner can require large letters of credits for security deposits which

allow the owner to draw on them if tenants fail to pay for the cost of their construction activities. The letters of credits may prove useful in bankruptcy situations because they constitute agreements between the owners and third parties and are not subject to attack by other creditors of the bankrupt. Another strategy the owner can use if mechanics' liens are filed as a result of a tenant's work, is to argue that if liens are filed after the bankruptcy filing, the liens create new post-petition defaults under the lease (which is another reason why all leases should state that it is a default under the lease if a lien is filed against the leased premises or the building resulting from the actions of the tenant). Failure to cure the new default is actionable in the bankruptcy proceeding.

Fourth, while not a comprehensive solution, an owner can require receipt of a payment and/or performance bond before allowing any tenant to perform any work in a building. The primary problem is that the owner would be relying upon the tenant to cause the general contractor to obtain the payment and/or performance bond from an insurance company or other type of surety before commencing the work. Further, a payment bond only guarantees that a general contractor will pay all subcontractors. As a result, while the owner can be certain that any and all subcontractor's will get paid, thus averting claims for subcontractor's mechanics' liens, the owner still has to trust that the tenant will pay the general contractor. A performance bond guarantees that the work will be completed in a good and workmanlike manner and in accordance with the provisions of the construction contract. While a performance bond does not shield an owner against the possibility

that a mechanics' lien may be filed, it does insure that work performed in an owner's building will be of good quality and will be what was specifically contracted for.

Lastly, in the event that the owner is aware of work being performed in the building that the owner has not authorized, the owner should immediately make objection to the contractor and/or materialman and confront the tenant as well. Any further work performed after notice is given to stop would be difficult to assert against the owner.

The time to start considering mechanics' lien issues is prior to construction. In a situation where a tenant is responsible for the performance and payment of a buildout, an owner should employ one or more of the foregoing suggestions in order to reduce the chances of a mechanics' lien being filed against the owner's fee interest. Otherwise, an owner's fee interest will be vulnerable to mechanics' lien claims as the owner may have an extremely difficult time convincing a court that the owner did not "*knowingly permit*" the construction or that the construction did not enhance the value of the building.