EFFECTS OF COMMERCIAL M & M LIENS ON A LANDLORD'S PROPERTY

By Brian D. Womac

It can be a shock for a landlord to receive a lien filing notice on a commercial property when the tenant contracted with a builder/contractor for a renovation that the landlord may or may not have known about. Sometimes tenants enter into agreements with a contractor or subcontractor to build-out a lease space without the landlord's knowledge or approval. When the tenant doesn't pay the contractor, the contractor files a lien notice against the property. In Texas, it is generally accepted that the mechanic's and materialmen's lien (M & M lien) will only attach to the leasehold estate or the tenant's interest. *Schneider v. Delwood Ctr., Inc.*, 394 S.W.2d 671, 673 (Tex.Civ. App.-Austin 1965, writ ref'd n.r.e.) Strictly speaking, unless the landlord is also a party to the construction contract or the tenant is the authorized agent of the landlord, no lien should attach to the real property. *Inman v. Orndorff,* 596 S.W.2d 236, 238 (Tex. Civ.App.-Houston [1st Dist.] 1980, no writ); *Rosen v. Peck*, 445 S.W.2d 241, 243 (Tex.Civ.App.-Waco 1969, no writ). It doesn't always turn out that way. And if a lien is filed, even wrongfully, a cloud on title is created, which could be a default situation with the landlord's lender if the lien isn't removed.

GENERALLY, THE M& M LIEN DOES NOT ATTACH TO THE BUILDING

Contractor liens are governed by Chapter 53 of the Texas Property Code. In Chapter 53, a contractor lien is valid only against the party who entered into the contract. In order to have a valid lien against the real property, the landlord would have had to be a party to the contract or ratified the contract by certain actions. *Inman,* 596 S.W.2d 236, 238. Texas case law confirms this view, as does the Texas Property Code, and offers protection to landlords as I will explain below.

Here is the situation where the landlord prevails. The case is *Triad Home Renovators, Inc. v. Dickey*, 15 S.W.3d 142, 144-146 (Tex.-App.-Houston (1st Dist.) 2000). In *Triad*, Triad and Rutherford performed construction work for the commercial tenants, Platter, Inc. and Italia Platter. The tenants failed to pay Triad for work and improvements to the lease space. Triad subsequently sued the landlord, Dickey, asserting that the tenants had an agency relationship with the landlord. The Court held that there was no agency relationship between the landlord and tenants. The fact that the landlord did not hire Triad, and that it was not a party to the contract with Triad, persuaded the Court to remove any lien filed by

the contractor against the landlord's property. Additionally, the Court found evidence existed that the landlord allowed the tenants to represent themselves. Ultimately, the landlord's lack of control over the build-out convinced the Court the landlord was not liable. This decision might have been different if the landlord had overseen and/or approved the work.

UNLESS THE LANDLORD ALLOWS THE TENANT TO ACT AS ITS CONTRACTOR

There are traps for landlords to fall into when tenants control the construction project for the landlord's property. One Texas case held that the landlord's interest could be liable by the builder's lien filing even though the contract was entered into directly with the tenant. Most commercial leases state that the relationship between the landlord and tenant was just that, and nothing more. The Texas Court of Appeals, out of Houston, held that the landlord and tenant also had a relationship of original contractor and subcontractor. Interestingly, the lease required the landlord to withhold 10% of the tenant's allowance, as most construction work letters do. In that situation, the Court found that although the landlord did not enter into a contract with the builder, the tenant essentially acted as a contractor for the landlord by managing the construction. *Bond v. Kagan Edelman Enterprises*, 985 S.W.2d 253, 258 (Tex. App- Houston (1st Dist.) 1999), rev'd in part on other grounds 20 S.W.3d 706 (Tex.2000).

There are a couple cases which commercial landlords need to be aware of. One is the *Bond* case mentioned above. In *Bond v. Kagan*, Kagan, the landlord of a shopping center, entered into a lease with Irwin, the tenant, for constructing a restaurant lease space. The landlord required the tenant to perform the build-out of the lease space prior to occupancy. The landlord agreed to provide a tenant allowance and retain 10% of the allowance in the work letter. The tenant hired Bond to perform the improvements to the restaurant. The landlord met with Bond prior to construction and provided him with interior specifications and requirements for the construction to confirm that the construction would comply with the shopping center specifications. The landlord's management inspected Bond's work weekly. No problem so far. For reasons unknown, the tenant runs out of money. As you can expect, the tenant defaulted on the rent payments to the landlord and failed to pay Bond. Bond demanded payment from the landlord since Bond improved the landlord's property and the tenant was broke. The landlord puts the tenant in default and doesn't pay Bond. Now Bond sues the landlord

for the money owed and to verify its lien against the landlord's property.

After a lengthy and expensive trial, the trial court ruled that the landlord wasn't liable. Does it end there? No, Bond files an appeal. And to the surprise of the landlord, the Houston Court of Appeals reverses the trial court's finding and holds the landlord liable. It appears Bond persuaded the Appeals Court that the tenant acted as the landlord's contractor in addition to other factors. Here are some of the factors to be aware of, and which the Court considered:

- The landlord provided a tenant allowance.
- The landlord retained 10% of the tenant allowance as dictated by the lease and Texas law.
- The landlord accepted a lien release from the tenant after receiving the notices from Bond.
- The landlord paid the tenant allowance to the tenant after receiving the lien notices.
- The landlord met with Bond initially and inspected the construction weekly.
- The landlord specified the construction requirements.
- The construction of the lease space was a condition precedent set by the landlord with the tenant.

Finding the above factors existed, the Court found that the landlord's relationship with the tenant was two-fold—a landlord and tenant and an owner and contractor. Consequently, the Court concluded that the landlord directed the tenant to act as his agent and became liable to the subcontractor. Not the outcome the landlord was expecting. But most landlords find themselves doing exactly what this landlord did for construction projects.

Due to *Bond v. Kagan,* Texas courts may be more inclined to hold landlords liable if the landlord acts as a manager for the tenant's build-out. For example, if the landlord oversees the construction, requires certain construction specifications and funds the construction through a tenant allowance, the courts may allow a lien to be placed against the landlord's property. This can be true even though the landlord was not a party to the tenant's contract with the builder.

CONTRACTORS MUST TIMELY NOTICE AND FILE LIEN AFFIDAVITS

If you, as a landlord, receive a notice of a lien filing, you need to take notice of the filing. If a contractor/subcontractor files a lien against the landlord's property, both the notice and the lien filing must be timely. Section 53 of the Texas Property Code requires certain filing requirements to be strictly followed. If the notice and/or lien filings are not timely, the lien will be invalid.

WHAT TO DO?

Similar to the above cases, the builder, as a contractor or a subcontractor, could lien the landlord's property upon non-payment by the tenant. This would create liability for the landlord not contemplated by the lease. Requiring a bond through bonding requirements in the lease for tenant improvements is strongly advised. More importantly, landlords should closely monitor any construction being performed on their property and require lien releases to be executed and delivered to the landlord prior to each disbursement to the tenant. Lien releases from subcontractors, as well as contractors, could protect landlords from lien filings due to non-payment.

A potential trap for landlords and property managers is the failure to use the statutorily-required release forms. Did you know that the Texas

Property Code requires landlords to use certain lien waiver forms? If you haven't updated your release forms lately, you probably are using outdated and unenforceable lien waiver forms. There are four (4) specific forms required. Two (2) of the forms are for a conditional release (one for progress payment and one for when payment is final). The other two (2) required forms are for an unconditional release when payment has been made (one for progress payment and one when payment is final). For your convenience, please see Texas Property Code Sections 53.283 and 53.284 for the four (4) statutorily required release forms.

CONCLUSION

If there is no contract between a landlord and a builder for the tenant's improvement, Texas law finds that a lien only attaches to the tenant's improvements and not the landlord's property. However, certain actions such as controlling the tenant's improvement and allowing the tenant to act as a contractor and agent, could trap an unsuspecting landlord. Lien filers must send timely notice and notice the liens to all required parties by statute. If not, the liens are not perfected, but will still cloud the landlord's property. A landlord can protect itself by requiring a bond and a lien release from both contractors and subcontractors as well as know what construction is taking place, and by whom, on the property. **N**

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