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Eric Allon and David Doyle - Do landlords guaranty payment of tenant-contracted improvements?

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Continuing a series of court decisions adverse to landlords, the Massachusetts Supreme Judicial Court recently found that a tenant's contractor had a valid lien on the owner's property because the owner consented to the work to be performed on the property. Though contractors may be delighted by the Trace decision, owners will need to review this decision and determine what lease changes are necessary related to landlord's "consent" to tenant's work.

Trace Construction, Inc. v. Dana Barros Sports Complex, LLC concerns the former professional basketball star, Dana Barros, who leased a 70,000 s/f building in southern Massachusetts to serve as the home for his basketball camp. Barros intended to transform a building that had been vacant for years and previously used as a wholesale paper business into a recreational facility. He signed a five-year lease with two five-year options and hired two contractors who performed extensive work on the premises, including plumbing, lighting, HVAC and electrical work. When not paid in full for their work, the contractors and two subcontractors took the necessary steps to perfect mechanic's liens for their work. Dana Barros surrendered the premises to landlord, and the landlord continued to operate the facility to generate income. The contractors and subcontractors proceeded to file actions to enforce the liens. A superior court judge, in a jury-waived trial, determined that the contractors and subcontractors had established valid liens against the tenant's leasehold interest, but not against the owner's property.

After the parties appealed, the Supreme Judicial Court of Massachusetts ("SJC") transferred the case on its own initiative from the Massachusetts Appeals Court and ruled (i) the contractors had a lien against the owner's property, (ii) the subcontractors did not, and (iii) any liens on the tenant's leasehold did not survive the tenant's surrender of the lease to the owner.

In making its decision, the SJC first focused on the wording in the section of the mechanic's lien statute applicable to contractors, specifically, whether the contract for the tenant's improvements was entered into "with the owner of any interest in real property or with any person acting... with the consent of such owner..." In Trace, the SJC interpreted these words to mean that if a tenant engages a contractor with the owner's consent, the contractor is entitled to a lien on the owner's interest in the property. Although the lease provided that landlord's written consent was required before Tenant commenced any alterations or improvements, there was no evidence that written consent was ever obtained, and the SJC stated that mere awareness of and acquiescing to work by a third party on the property did not create consent. However, the SJC found other factors that evidenced the owner's "consent" which included: (a) the lease restriction that allowed use only for a

recreational facility; (b) renovations were extremely likely, even though tenant improvements were not required of the tenant; (c) the lease expressly provided that any improvements were to remain for the benefit of the landlord and not be deemed the property of the tenant; and (d) the landlord testified at trial that it set the rent attractively low to encourage the tenant to make an investment in the property.

The subcontractors did not fare as well. The SJC noted that the mechanic's lien statute applicable to the subcontractors did not have any language relating to the owner's consent. Because of that statutory difference, the subcontractors could not claim a lien against the owner's property.

Following the Trace decision, if a landlord's "consent" was intentionally given or deemed granted by implication, a contractor who entered into a contract with a tenant may lien a landlord's property and look to landlord for payment. Consequently, after considering the cost and scope of tenant's work, the financial creditworthiness of the tenant and the extent to which the work benefits a landlord's property, a landlord should consider whether it should impose requirements specifically to protect the property against the impact of a lien for unpaid improvements such as a construction security deposit or lien bond. In any event, the holding in Trace will significantly affect various aspects of real estate in the coming years.

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