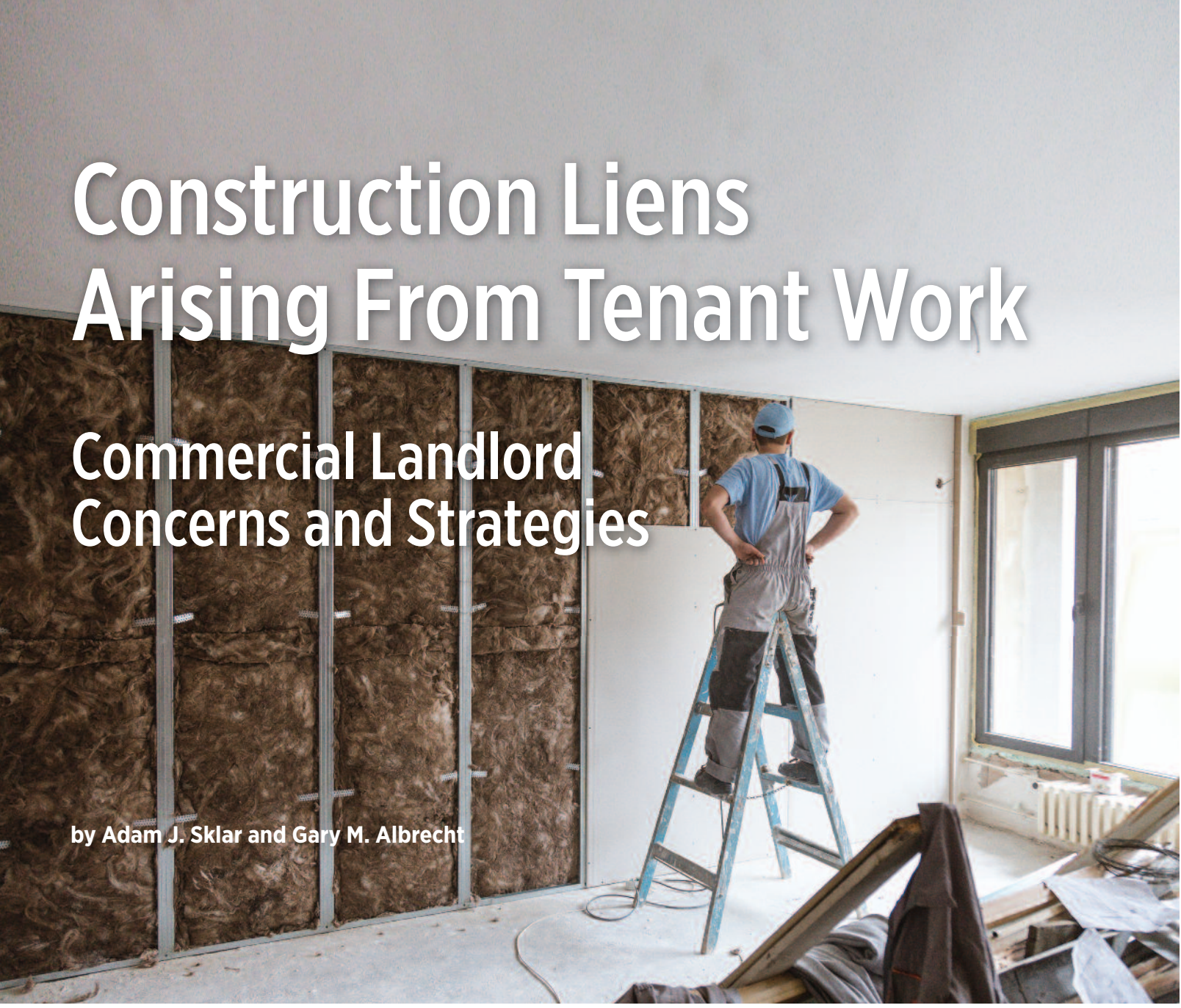
Construction Liens Arising From Tenant Work

Commercial Landlord Concerns and Strategies



by Adam J. Sklar and Gary M. Albrecht

ADAM J. SKLAR *is a member of the construction services group and litigation department at Cole Schotz P.C. located in Hackensack. He has represented companies and individuals from across the country in complex construction disputes and business litigation, and has moderated and presented at numerous seminars on the New Jersey Construction Lien Law and other construction and business-related issues.*

GARY M. ALBRECHT, *co-chair of the real estate department at Cole Schotz P.C. located in Hackensack, has a national commercial real estate practice providing counsel on the acquisition, financing, brokerage, development and sales of commercial real estate with a particular emphasis on retail leasing and development and the adaptive re-use of former retail projects.*

One of the least understood and least examined aspects of the New Jersey Construction Lien Law[1] is the scope of the lien rights of one who provides work or materials in connection with a commercial tenant's improvements to its leased premises. That is, does the potential lien claimant have a right to file a construction lien against the landlord's fee interest in the real property, or is it limited to a lien against the leasehold interest of the tenant for whom it provided the work or materials? The answer is—it depends on the circumstances. But most of the time, in practice, the lien will *not* extend to the landlord's fee interest. This article will examine construction lien rights in connection with tenant work, the effect of a construction lien on commercial rental property and what actions a commercial landlord and its tenant can take when confronted with a construction lien.

Relevant Lien Law History Regarding Tenant Work

The Construction Lien Law became effective in 1993, replacing the old Mechanic's Lien Law and introducing the term 'construction lien' into the lexicon of New Jersey law in lieu of 'mechanic's lien.' In 2010, the law was substantially amended by the Legislature, with those revisions being signed into law on Jan. 5, 2011, effective immediately. Among other things, the omnibus revisions sought to clarify certain extant provisions, to codify certain case law interpreting the lien law, and to address certain perceived inequities in the law upon further consideration. One of the issues the Legislature revisited and addressed was the circumstances under which a construction lien might attach to a property interest other than just the tenant's leasehold interest where it was the tenant that contracted for the subject real property improvement.

Prior to the 2011 revisions, the relevant Construction Lien Law statute, N.J.S.A. 2A:44A-3, provided, simply, that "[i]f a tenant contracts for improvement to the real property, and the contract for improvement has not been authorized in writing by the owner of a fee simple interest in the improved real property, the lien shall attach only to the leasehold interest of the tenant." That language was a change from the former Mechanic's Lien Law, which had allowed a lien to be placed on the owner's fee interest if "such alteration, repair or addition was made with the written consent of the owner of such land." So, when enacted, the Construction Lien Law contained similar language but required that the "contract for improvement" itself had to be approved in writing by the owner. Thus, the language was significantly more restrictive than under prior law, and the circumstances under which a lien could be filed against the owner's interest would, in practice, be rare.

Prior to the revisions, two unpublished Appellate Division cases highlighted the Construction Lien Law's strict requirement that the contract for improvement had to be specifically approved by the landlord for the lien to attach to the landlord's fee interest. In the first case, in 2007, *Cherry Hill Self Storage, LLC v. Racanelli Construction Co., Inc.*,[2] the court found that a provision in the landlord's lease with the subject tenant requiring the tenant perform the work at issue did not satisfy the statutory requirement of written approval of the contract for the improvement itself. In the second case, in 2009, *The Benmore Construction Group, Inc. v. Herod Rutherford Developers, L.L.C.*,[3] the court noted that a lien could not have attached to the landlord's interest where, despite the landlord having approved the tenant's proposed work, it never approved the specific contract for the work itself.

The *Cherry Hill Self Storage* decision clearly did not sit well with the contractor community, and the real or perceived unfairness to potential lien claimants in this restrictive Construction Lien Law section as applied by the Appellate Division was, thereafter, considered and addressed as part of the New Jersey Law Revision Commission's report to the Legislature relating to the proposed law revisions. In the commission's comment to this section in its March 2009 final report relating to the lien law revisions, the commission specifically noted that the proposed revision to this section:

> attempts to counter the effect of the court holding in *Cherry Hill Self Storage*..., which required the landlord to authorize in writing a contract for improvement by a tenant to a leasehold property even though the lease provided that the tenant was permitted to contract to have the work done, the landlord was required to contribute to the work to be done in the form of a rent credit, and the landlord had the right to compel the tenant to make certain modifications in the building plans. In practice, the lease may not provide that the landlord approve each and every improvement proposed by the tenant. The tenant's ability to obtain written authorization for a proposed improvement in a timely fashion often may not be possible. The landlord, however, should not be obligated to bear the burden of a lien if the landlord has done nothing more than sign a lease that contemplates a tenant improvement. The proposed modification... attempts to address those instances where the lien should attach to any other interest in addition to the leasehold interest.

The Revised Current Lien Law Section Regarding Tenant Work

Thus, in an attempt to address these concerns and strike a reasonable balance between the contractors' interests in filing a lien against the landlord's improved fee interest and the landlord's interest in not being saddled with a lien relating to

improvements with which it had little or no direct involvement, the Legislature, based on the *Law Revision Commission's Final Report*, revised Construction Lien Law Section 3(e) as follows:

> If a tenant contracts for improvement of the real property, the lien shall attach to the leasehold estate of the tenant and to the interest in the property of any person who:
>
> 1. has expressly authorized the contract for improvement in writing signed by the person against whom the lien claim is asserted, which writing provides that the person's interest is subject to a lien for this improvement;
> 2. has paid, or agreed to pay, the majority of the cost of improvement; or
> 3. is a party to the lease or sublease that created the leasehold interest of the tenant and the lease or sublease provides that the person's interest is subject to a lien for the improvement.

Thus, the Construction Lien Law provides three discrete situations, via three statutory subsections, in which a lien may be filed against a property interest other than the leasehold interest. The first subsection tracks the original Construction Lien Law language, requiring the specific contract for improvement to be "expressly authorized" in writing by the person against whom the lien is asserted—but also requires that the written authorization be signed and that it explicitly provide that the person's interest is subject to a lien for the improvement. The authors have never come across a situation where a landlord has ever or, frankly, would ever expressly authorize in writing that its property may be subject to a lien in connection with work performed by its tenant.

The second subsection, on the other hand, is, without question, the most likely of the three situations to result in a lien being filed against the landlord's interest. This provision was a true broadening of lien rights, expanding greatly on the lien law's limitation regarding written contractual approval. Thus, for example, if the landlord has provided rent credits or a tenant improvement allowance, in an amount that ends up being more than half of the actual construction costs, then that may be deemed as the landlord having paid or agreed to pay "the majority of the cost of the improvement." As the Law Revision Commission commented in regard to *Cherry Hill Self Storage*, the landlord in that case "was required to contribute to the work to be done in the form of a rent credit," thus providing context for this provision and its intention to extend to rent credits and the like, and not simply where the landlord makes direct payments to the tenant's contractor. Although there is no case law on this issue, in light of the foregoing a court would likely determine that rent credits, improvement allowances and other credits or payment to the tenant specifically relating to the tenant work would satisfy the landlord 'payment' requirement, enabling a tenant's contractor to lien the landlord's fee interest, if such 'payment' equaled more than half of the cost of the work.

The third subsection, like the first, is rarely satisfied. Indeed, it would be surprising if, in practice, any lease provided that the landlord's interest was subject to a construction lien for the improvement itself. Typically, in fact, a standard commercial lease would explicitly provide the opposite—that is, that the tenant is responsible for ensuring that no lien is filed against the landlord's interest for work performed by or for the tenant, and the tenant would be obligated to remove any such lien and defend and indemnify the landlord regarding any claim made in connection with any such lien.

It is also worth noting that the revised language expanded the property interests against which a construction lien could attach to more than just the owner's fee simple interest. The amendment now accounts for subleases and ground leases, such that, for example, a contractor performing work for a sublessee could possibly lien the sublessor's interest, in addition to the sublessee's leasehold interest, if it meets the statutory criteria—even if it may not have the right to lien the owner's fee interest.

Practical Implications of a Lien Filed Against the Landlord's Fee Interest

Generally, in New Jersey, the rule of lien priority is first in time, first in right.[4] The Construction Lien Law specifically provides that a mortgage or deed filed with the county clerk's office before a construction lien is filed has priority over that later-filed lien, and, in certain enumerated circumstances, a later-filed mortgage also may have priority over a construction lien.[5] Even so, a construction lien, whether filed against an owner's fee interest or just against the tenant's leasehold interest, may cause serious problems for the owner, as well as the tenant.

The filing of a construction lien is a powerful tool for the claimant, as a sale or mortgage financing may be delayed (or theoretically prevented) as a result thereof. In real estate transactions there are deadlines to meet. A loan commitment will have an expiration date. A purchase and sale agreement will set deadlines for contingencies to be met and may, for example, establish a time of the essence closing requiring the parties to close on a date certain. Title insurance policies must be issued at the time of closing to protect the interests of owners, lenders and, sometimes, tenants. A 'standard exception' to coverage under a title insurance commitment is "any lien or right to a lien for services, labor or material heretofore and hereafter furnished, imposed by law and not shown by the public records." Prudent insureds under owner's and lender's title insurance policies will require the removal of this exception.

The filing of a construction lien against fee or leasehold interests constitutes a title encumbrance, and title insurers will make a specific exception for the lien from its commitment to issue title insurance. Such a filing may also adversely affect the ability to persuade the title insurer to remove the standard lien exception. A prospective purchaser is unlikely to close on the acquisition of real estate and a lender is not likely to fund a loan with a construction lien in place and an exception for such a lien in its title insurance policy. While the lien may be discharged by payment to the lien claimant, by court order, or by bond or cash deposit (all as provided pursuant to the Construction Lien Law), not all of these methods are practical when the parties to a purchase and sale and/or financing may not have the luxury of time due to the terms of the contract or loan commitment.

One way for an owner to protect against a last minute filing of a construction lien interfering with a closing on the acquisition or financing of real estate is to file a notice of settlement with the applicable county clerk's office. A notice of settlement is a recorded document that notifies the public that an impending settlement (*e.g.*, closing) affects an interest in real property. The lien law provides that a construction lien is subject to the effect of a notice of settlement.[6]

A construction lien may also cause difficulties for an owner developing its property. For example, if an owner has procured construction financing to develop its real estate, and a construction lien is filed against its fee interest based on a tenant's work, the owner's construction financing draw(s) will likely be delayed or otherwise adversely affected. To protect its own security interest in the real estate and to satisfy requirements of the title insurance company insuring the construction loan, a lender will cause 'rundown' searches of title to be performed before disbursing draws of funding from the construction loan. If a construction lien appears on that search, whether against the fee or leasehold interest (and whether or not the lien would actually affect the priority of the construction lender's mortgage), the lender will likely require the lien to be discharged prior to the release of any additional draws to the owner. In fact, a construction lien filed against the mortgaged property may, in and of itself, constitute a breach of the owner's loan covenants.

Similarly, in a typical commercial lease, the mere filing of a construction lien may violate the terms of the lease. In most leases, the landlord requires all liens resulting from the tenant's work (or alleged to have resulted from the tenant's work) to be discharged by the tenant within a certain period of time following the landlord's written demand. In the normal course, the tenant may obtain a discharge by any of the methods provided in the lien law. However, a tenant's options may be limited due to the time constraints in its lease, and it may not be able to challenge the validity of the lien within the time granted under the lease. If the tenant fails to cause the lien to be discharged in a timely manner, it can be declared in default of the lease and subjected to various landlord remedies under the lease, often including a right of 'self-help' allowing the landlord to discharge the construction lien on its own and charge the tenant for all costs incurred in connection with doing so.

If a landlord is providing funding toward the cost of the tenant's work, it is prudent for the landlord to pay out the allowance in installments as the work proceeds, and condition each installment on receipt of construction lien waivers from all contractors, subcontractors and suppliers. A contractor, subcontractor, or supplier may waive the right to claim a construction lien by executing a lien waiver only to the extent that payment is actually received by the party signing the lien waiver, but obtaining these lien waivers as payments are made will at least limit the amount of any potential construction lien claim.[7]

Challenging a Lien Improperly Filed Against Fee Interest

If the lien is filed against the landlord's fee interest, the landlord and tenant should determine whether the Construction Lien Law Section 3(e)'s statutory requirements have been met. If they have not, and the claimant had no right to lien the landlord's interest, either party may send a letter to the lien claimant demanding that if the lien is not discharged voluntarily by a set date, the landlord or tenant will file an action seeking the discharge by court order. The landlord or tenant instead may choose to proceed directly to court through an order to show cause summary proceeding, as sanctioned by Construction Lien Law Section 30, to have the lien claim discharged. Or, the tenant may decide, rather than litigate, it is best to simply bond the lien, which will serve to discharge the lien, and await an enforcement action from the lien claimant against the bond, which the tenant would defend in the same manner.[8]

Construction Lien Law Section 15 provides for severe penalties where "a lien claim is without basis, the amount of the lien claim is willfully overstated, or the lien claim is not lodged for record in substantially the form or in the manner or at a time not in accordance with this act…." 'Without basis' is defined as "frivolous, false, unsupported by a contract, or made with malice or bad faith or for any improper purpose."[9] If the court determines any of the foregoing grounds are met, the lien claimant "forfeit[s] all claimed lien rights and rights to file subsequent lien claims to the

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and restrictions on permitted occupancy as a result of contractual lease obligations to other tenants, and (v) shall have no greater obligation with regard to its efforts to mitigate damages than the efforts made by Tenant itself to mitigate damages prior to or after default by Tenant. ⚖

Endnotes

1. The grease was so thick one could not walk under the former location of the oven in the summer weather when the roof was heated by the sun without the grease dripped like April showers.
2. This remedy is not applicable to all covenants governing tenant deliverables, such as subordination, non-disturbance and attornment agreements (SNDAs), where lenders may have used the SNDA to make changes to the lease and where it would be unfair and prejudicial to the tenant to trigger liquidated damages when tenant's counsel may be negotiating the SNDA form in good faith.
3. The New Jersey Supreme Court has held that a landlord has an obligation to mitigate damages arising from the breach of a commercial lease. *McGuire v. City of Jersey City*, 125 N.J. 310, 320, 593 A.2d 309, 314 (1991). *See also*, *Fanarjian v. Moskowitz*, 237 N.J. Super. 395, 407, 568 A.2d 94, 100 (App. Div. 1989); *Harrison Riverside Limited Partnership v. Eagle Affiliates, Inc.*, 309 N.J. Super. 470, 707 A.2d 490 (App. Div. 1998); *Ringwood Associates, LTD v. Jack's of Route 23, Inc.*, 166 N.J. Super. 36, 398 A.2d 1315 (App. Div. 1979); *Carisi v. Wax*, 192 N.J. Super. 536, 471 A.2d 439 (Bergen County Dist. Ct. 1983); and 2 Andrew R. Berman, F*riedman on Leases* §§16.03, 16:3.1[B], 16:3.1[C] (6th Ed. 2017).
4. *See*, *Borough of Fort Lee v. Banque National de Paris*, 311 N.J. Super. 280, 710 A.2d 1 (App. Div. 1998); *Jaasma v. Shell Oil Company*, 412 F.3d. 501 (3rd Cir. 2005).
5. Relevant criteria in selecting a replacement tenant may include, but are not limited to, credit history, negative references from prior landlords, concern over the environmental impact of the business, any change or intensification of use of the premises and restrictions on permitted occupancy as a result of contractual lease obligations to other tenants.
6. *See*, *Sommer v. Kridel*, 74 N.J. 446 (1977).

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extent of the face amount claimed in the lien claim" and is liable for all reasonable legal expenses incurred by any party obtaining the lien's discharge.

While it is unclear that a lien claimant that performed tenant work and then erroneously, but innocently, filed a construction lien against the owner's fee interest would be found to have violated any of the grounds for forfeiture, at the very least if shown to have been wrongfully filed against the fee interest, the court should still summarily order the discharge of the lien. The claimant, thereafter, may be precluded from re-filing its lien even if just by the expiration of the strict 90-day limitations period to file a lien from the claimant's last date of work or provision of materials.[10]

Conclusion

A construction lien resulting from tenant work may be filed against a landlord's fee interest in only limited statutory circumstances. A construction lien wrongly filed against the landlord's fee interest will subject the lien to discharge. Even if properly filed only against the leasehold interest, a construction lien may still cause a variety of problems for a landlord, particularly if it seeks to sell, develop or refinance the property. The landlord generally will have recourse in its lease against its tenant requiring the tenant to discharge the lien, though delays may result. The safest course is for tenants, and their landlords, to maintain as many strict controls over the construction process on their property as possible to attempt to ensure that no construction liens are filed in the first place. ⚖

Endnotes

1. N.J.S.A. 2A:44A-1, *et seq*.
2. *Cherry Hill Self Storage, LLC v. Racanelli Construction Co., Inc.*, Docket No. A-5727-05T5 (N.J. App. Div. June 18, 2007).
3. *The Benmore Construction Group, Inc. v. Herod Rutherford Developers, L.L.C.*, Docket No. A-2460-08T2 (N.J. App. Div. Nov. 18, 2009).
4. *Sagi v. Sagi*, 386 N.J. Super. 517, 524-25 (App. Div. 2006).
5. N.J.S.A. 2A:44-10; N.J.S.A. 2A:44-22.
6. N.J.S.A. 2A:44A-10.
7. N.J.S.A. 2A:44A-38.
8. N.J.S.A. 2A:44A-14, -24.1; N.J.S.A. 2A:44A-31.
9. N.J.S.A. 2A:44A-15d.
10. N.J.S.A. 2A:44A-6a(2).