Court of appeals decision holds that lease terms alone may impose liability upon landlords for mechanic's liens filed as a result of a tenant build-out - by Maurizio Anglani

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Commercial leasing in New York often involves improving the leased premises for the tenant's specific use. This process, known in the industry as the tenant build-out, is frequently the subject of negotiations between landlords and tenants. In some situations, the landlord keeps direct control over the build-out by hiring the design and construction team directly. Other times, it is the tenant's responsibility to perform the improvement at its sole cost and expense. In these instances, the landlord expects that the tenant will be solely responsible for paying the construction and design team. However, the landlord may still be liable to unpaid designers and contractors, even if hired directly by the tenant.

Under N.Y. law, unpaid designers, laborers and materialmen hired by a tenant may file mechanics' liens against the landlord and landlord's property in order to secure their claims for unpaid sums, even in the absence of a contractual relationship with the landlord. Once filed, mechanic's liens act as a cloud on title on the landlord's property, thereby affecting the landlord's right to convey the property or seek financing. Moreover, mechanic's liens can be enforced directly against the landlord's fee interest through a foreclosure action, which can lead to a sale of the property to satisfy the lien. In order to mitigate these risks, leases often include provisions requiring the tenant to obtain lien waivers from contractors and to bond any mechanics' liens filed against the property. These protections may not be sufficient however, when a tenant encounters financial hardship during the improvements; unpaid designers and contractors will look to the landlord for payment by seeking enforcement of their mechanic's liens, and the landlord will not be able to obtain satisfaction of the liens or a bond from the tenant.

The landlord's liability for mechanic's liens arising out of a tenant build-out depends on whether the landlord "consented" to the improvements within the meaning of Section 3 of the lien law. The landlord is deemed to have consented to the tenant's improvements if the landlord was either (a) an affirmative factor in procuring the improvement to be made, or (b) in possession and control of the premises and assented to the improvement in the expectation that the landlord would reap the benefit thereof. Mere passive acquiescence in or knowledge of improvements being made is not

sufficient. Consent by the landlord may be expressed or implied, it may be found in the terms of a lease, in the landlord's conduct, or a combination thereof. If the lease is silent as to the improvements, courts will look to any other affirmative acts of consent by the landlord. More commonly, however, leases are not silent and include several provisions regarding the tenant's alterations to the demised premises.

The extent to which lease provisions can serve as a basis for "consent" was subject to a split between the appellate courts of the first, second, and third department on the one hand, and the fourth department on the other. Several cases in the first, second, and third departments held that a provision in a lease whereby the landlord grants permission to the tenant to make alterations or improvements in the premises is not to be construed as consent to mechanics' liens. The fourth department rejected this view, and held that a lease provision providing that the tenant may make certain improvements on the premises is a sufficient consent of the landlord to charge it and the property with responsibility for mechanic's liens which accrue in making those improvements.

This split of authority was recently addressed by the court of appeals in Ferrara v. Peaches Cafe LLC, 2018 NY Slip Op 07925 (2018). In Ferrara, the tenant hired a third-party contractor, the plaintiff, to perform electrical work on the property. Immediately after opening for business, the tenant closed its doors without paying the plaintiff for the completed work. Thereafter, the plaintiff filed a mechanic's lien against the property for $50,000. The plaintiff then commenced a foreclosure action against the tenant and the landlord. The landlord moved for summary judgment, arguing that the landlord had not "consented" to the improvements. The supreme court granted the landlord's motion, and the appellate division then reversed.

The court of appeals held that "consent" could be inferred solely from the terms of the lease and that there was no "requirement that [a landlord] either expressly or directly consent to the improvements." This holding seems to undermine several appellate division cases from the first, second, and third departments, which indicated that simply consenting to the improvements under terms of the lease was not sufficient to impose liability under the lien law. Yet, the court stated that these appellate division decisions were actually consistent with the court's decision. The court explained that the language of the lease agreement in Ferrara not only expressly authorized the tenant to undertake the electrical work, but also "required" it to do so. This could arguably be interpreted to mean that, in deciding whether lease terms constitute "consent" from the landlord, the determining factor will be the degree to which the lease "requires" the improvements as opposed to merely acquiescing in the improvements.

This recent decision highlights the important role of lease terms to determine a landlord's liability for a tenant's improvements. Although the precise extent to which lease terms may or may not result in liability is to be determined by future cases, it is clear that a landlord should be very careful when drafting terms of a lease. It's also important to find a reputable attorney who can assist in a variety of landlord/tenant issues to reduce the risk of liability.

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