NEWS Release

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LIEN IN: Landlords, Tenants, and Construction Liens

Unpaid contractors sometimes register a construction lien on title to the property where their work was done. These liens can create problems for property owners, who may become exposed to liability even if they did not contract for the work. This article explains the nature of construction liens, some problems they create for landlords, and ways landlords can mitigate their impact.

Lien Basics

All common law provinces have legislation that grants those who improve real property by supplying services or materials ("contractors") with a security interest in the real property equal to the value of the services or materials they provided - this is called a "construction lien". When a contractor has not been paid for work done, it can pursue two legal routes for payment. First, it can sue the party who hired it for breach of contract. Second, it can register a lien against the improved property and pursue a court-ordered sale of the property to satisfy the debt.

Under a lease, each of the landlord and the tenant hold distinct "real property interests." The tenant holds a "leasehold interest" that gives it a right to exclusive possession of the premises. The landlord's interest is typically "fee simple", which is essentially a higher level of ownership. When a tenant improves its premises, one or both of these interests can become encumbered by a construction lien.

A construction lien registered on title, be it against the landlord's interest or the tenant's interest, may disrupt the landlord's normal course of borrowing. A sale transaction can also be impeded by a lien against either interest.

"Owner"

Ontario's Construction Lien Act ("CLA") provides that construction liens encumber the interest of an "Owner". The CLA provides a specific definition of Owner that often creates confusion. For the purpose of construction liens, an Owner is one who meets the following three criteria:

1. they have an interest in the property;
2. they requested the improvement of the property; and
3. the improvement was made on their credit or behalf, or with their privity or consent, or for their direct benefit.

When a tenant hires contractors to improve its premises, the tenant will meet the three criteria and a lien may be registered against the tenant's leasehold interest. However, a landlord may inadvertently also meet the three criteria. If it does, a lien may be registered against the landlord's interest.

Court decisions have addressed when a landlord will satisfy the "Owner" test. The decisions do not provide a bright-line test for landlords wanting to avoid a lien encumbering their interest. In *Pinehurst Woodworking Co. v Rocco*, the Supreme Court of Ontario held that approving drawings and plans does not amount to a "request" sufficient to bring the landlord within the definition of Owner. In *Haas Homes Ltd. v March Road Gym & Health Club Inc.*, the Ontario Superior Court held that providing a tenant allowance does not in and of itself mean the improvement was done on the landlord's "credit" for the purpose of the "Owner" test.

Nevertheless, various actions by a landlord that do not individually satisfy parts of the "Owner" test, when taken together, may be sufficient to render the landlord an Owner. In *Parkland Plumbing & Heating Ltd. v Minaki Lodge Resort 2002 Inc.*, the Ontario Court of Appeal explained that the "absence of direct dealing between [a landlord] ...and construction suppliers is only one factor to consider" and that "a 'request' for work to be done may be inferred from the totality of the circumstances."

Given the imprecision of the case law on the test to qualify as an "Owner", it can be difficult to know when a landlord will meet the definition. Basically, there is a chance that a landlord's property interest may be liened by a tenant's contractor, so landlords take pains to avoid this outcome.

Liability Notices

Another way in which a contractor may obtain a lien on the landlord's interest, independent of the landlord's degree of involvement in a tenant's improvements, is through a statutory mechanism.

Pursuant to Section 19(1) of the CLA, if a contractor notifies a landlord of improvements to be made to a tenant's premises and the

landlord **does not respond within 15 days disclaiming liability**, the contractor may lien the landlord's interest.

While the CLA provides standard-form templates for a contractor's notice and a landlord's disclaimer, these forms are not obligatory. As a result, there is some uncertainty as to what constitutes sufficient notice to expose a landlord's interest to a contractor's lien. In *Pinehurst Woodworking Co. v Rocco*, the Supreme Court of Ontario held that the notice must be sufficiently "arresting" or "attention getting." In *1276761 Ontario Ltd. v 2748355 Canada Inc.*, the same Court held that the notice must be sufficiently "distinct or memorable." While these decisions are instructive, they do not establish precise requirements for Section 19(1) notices. Some correspondence from a contractor could be sufficient to expose the landlord's interest to the contractor's lien, if it is clear and "attention getting".

Landlords should carefully study all correspondence received from tenants' contractors and, if applicable, respond within 15 days disclaiming liability.

Liens on the Leasehold Interest

When a tenant improves its premises, the tenant meets the definition of Owner. Therefore, an unpaid contractor may register a lien against the tenant's leasehold interest. There are two aspects of these "leasehold liens" that are uncertain:

1. What rights does the lienholder have?

2. What happens to the landlord's lease rights in the liened premises?

Ultimately, a lienholder's remedy is to force the sale of the charged property to satisfy the debt. When the charged property is a lease, can a lienholder assign the lease to a new tenant? Would this transfer require the landlord's consent? Can a lienholder take possession of the premises? These questions have not been decided by a Court and therefore remain unanswered.

If a lien is registered, Section 19(2) of the CLA prohibits the landlord from terminating the lease for any lease default other than non-payment of rent. If a lien is present when the tenant breaches an operating covenant, a use clause, a repair or insurance obligation, or assigns or sublets without the landlord's consent contrary to the lease, the landlord may wrestle with remedies for these potentially devastating non-rent defaults.

Some leases contain a right to use self-help remedies to cure the tenant's defaults and charge the cost of so doing to the tenant, as rent. "Monetizing" a default in this way might restore the landlord's right of termination despite Section 19(2), but it may not be practical or effective.

"Bonding-Off"

Some landlords go to great lengths to ensure their title remains lien-free. Bonding-off the lien is a way to remove it from title without addressing the contractor's grievance. Under the CLA, either the landlord or the tenant may pay an amount equal to the value of the lien claim into court, plus 25% for costs. (Although this is commonly referred to as a "bond," it is generally done by way of cash or letter of credit.) The amount paid into court serves as alternate security to which the lien attaches. The lien may then be removed from title.

For all of the reasons explained above, it is customary for leases to require tenants to (1) covenant to pay all contractors; (2) grant the landlord the right to bond-off any lien that is registered on title (with the expense of this remedial action being recoverable as additional rent); and (3) prove that they have paid all contractors and wait out the construction lien filing period to prove that no liens have been filed before receiving payment of a tenant allowance.

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