

NEVADA TENANT IMPROVEMENT CONSTRUCTION: A Refresher for Real Estate Counsel

BY LEON F. MEAD II, ESQ. AND DONALD "BUTCH" WILLIAMS, ESQ.

Las Vegas' real estate market is back. With pro football and hockey, and new industry galore, the construction industry is starting a new boom. Contractor license applications are way up. The Las Vegas Review-Journal recently reported that more than 1,300 contractors attended a kick-off bidder meeting for the Las Vegas Raiders Stadium – about 1,000 more than typically attend such meetings. New commercial tenant leases are not far behind, increasing real estate lawyers' leasing work and, in turn, tenant improvement construction contracts. In Nevada, this is where things get complicated...

With very few exceptions, every tenant *must* provide security for payment to contractors performing the work. NRS 108.2403(1) specifically provides:

[B]efore a lessee may cause a work of improvement to be constructed, altered or repaired upon property that the lessee is leasing, the lessee shall:

- (a) *Record a notice of posted security with the county recorder ... and*
- (b) *Either:*
 1. *Establish a construction disbursement account and*
 - I. *Fund the account in an amount equal to the total cost of the work of improvement ...;*
 - II. *Obtain the services of a construction control to administer the construction disbursement account; and*
 - III. *Notify each [potential mechanics lien claimant] of the establishment of the construction disbursement account; or*
 2. *Record a surety bond for the prime contract that meets the requirements of NRS 108.2415 and notify each [potential mechanics lien claimant] of the recording of the surety bond....*

NRS 108.2403(1).

Effects of Not Posting Security

In practical terms, this requirement is often overlooked by lessors, lessees and their lenders, perhaps because they are unaware of it. As the Nevada Supreme Court recognized, Nevada's mechanic's lien law is unique among the United States. *In re Fontainebleau Las Vegas Holdings LLC*, 128 Nev. ____, 289 P.3d 1199, 1211 (2012). Often, developers and their



PHOTO BY SCOTT G. WASSERMAN, ESQ.

counsel do not think about mechanics liens or the impact of the local mechanics lien law on their projects. But in Nevada, they dismiss this factor at their peril—the contractor’s remedy under NRS 108.2403 for a lack of “posted security” is formidable:

3. *If a lessee fails to [provide posted security], the prime contractor who has furnished or will furnish materials or equipment for the work of improvement may stop work. If the lessee:*
 - (a) *Satisfies the requirements [of posted security] within 25 days after any work stoppage, the prime contractor ... shall resume work and [is] ... entitled to compensation for any reasonable costs and expenses ... incurred because of the delay and remobilization; or*
 - (b) *Does not satisfy the requirements [of posted security] within 25 days after the work stoppage, the prime contractor ... may terminate the contract ... and [is] entitled to recover:*
 - (1) *The cost of the work ... including any overhead ... and profit ... earned through the date of termination;*
 - (2) *The balance of the profit the prime contractor ... would have earned if the contract had not been terminated;*
 - (3) *Any interest, costs and attorney’s fees ..., and*
 - (4) *Any other amount awarded....*

Perhaps more significant to lessor’s counsel, a Notice of Non-Responsibility (that arguably protects a lessor’s property interest from mechanic’s liens arising from a tenant improvement under NRS 108.234) is unenforceable if the tenant fails to provide the posted security required by NRS 108.2403. *See* NRS 108.234(7), noting that the definition of “disinterest owner” “does not include an owner who is a lessor if the lessee fails to satisfy the requirements set forth in NRS 108.2403 and 108.2407.” It is not sufficient, therefore, to simply push the posted security

requirement down to the tenant. If the lessee considers the Notice of Non-Responsibility to be a key component of its mechanic’s lien protection strategy, the lessor’s counsel cannot forget about the need for the tenant to provide posted security. The problem here, however, is what suffices as posted security can be a deal breaker.

Sufficient Posted Security


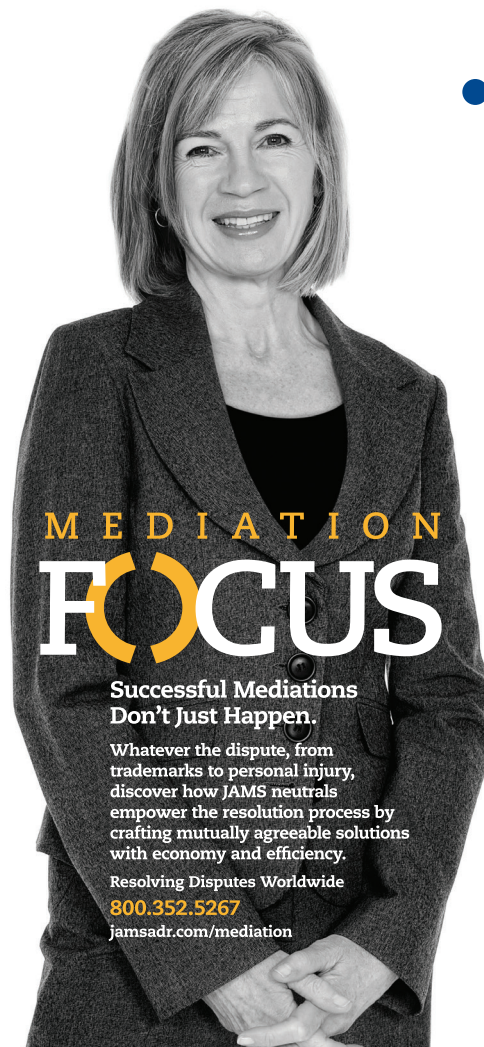
As noted above, posted security can take one of two forms:

1. Establishing and funding a construction disbursement account and retaining a construction control company to maintain it, or
2. A recorded surety bond that complies with NRS 108.2415.

While at first glance these requirements may not seem much of an impediment, looking more closely reveals the problematic nature.

Under NRS 108.2403(1)(a)(II), the construction disbursement account must be funded in the full amount of the tenant improvement construction, or at a minimum, the amount of the prime contract. NRS 108.2407(2)(a) also imposes a requirement that additional funds be paid into the

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account to cover any change orders before the change order work is performed. For a small tenant improvement, this may not be an issue. However, if the tenant improvement is an entire structure built on a long-term ground lease, having to fund the entire cost of the construction before the work commences could (and in most cases does) make the project a non-starter. Nevertheless, that posted security is required in a long-term ground lease as well, with the sole exception being “a ground lease designated for use or development by the county (with a population of 700,000 or more) for commercial purposes compatible with operation of the international airport for the county.” See NRS 108.2405(1)(a).

One might raise the question of whether a construction loan account managed by the construction lender could suffice for posted security. While this may be allowed if the construction escrow account is fully funded, as opposed to only funded to the extent of the current payment due for the work, the provisions of NRS 108.2407 are not usually compatible with the terms of most construction loan agreements. For instance, the lien claimants have a lien upon the funds in the construction disbursement account (NRS 108.2407(1)), and the construction control is obligated to interplead the funds in the construction disbursement account

if they are not sufficient to cover all the construction work (NRS 108.2407(6)). Most construction loan account terms favor the lender over the lien claimants in a construction loan, and imposing the other obligations of NRS 108.2407 upon the construction lender is not likely to pass the lender’s underwriting requirements.

The option to provide a surety bond is not much better. NRS 108.2403(1)(b) allows for the recording of a surety bond as posted security, but requires the bond to comply with NRS 108.2415(2). NRS 108.2415(2) requires the bond to be in the principal sum of 150 percent of the amount of the prime contract. Its initial impact, felt by the tenant here, is the bond premium, which adds 2 percent to 3 percent to the cost of the work of improvement, per year. For a \$750,000 surety bond (for a \$500,000 project), a \$15,000 premium *may* be an inconvenience, but on a \$1 billion resort project having to add a \$1.5 billion surety bond with an annual \$3 million bond premium may very well end the project. This does not even mention the surety’s requirement of asset pledges to protect it upon bond issuance, which can by itself eliminate the tenant’s ability to qualify for the surety bond.

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Exceptions

As noted above, there are two limited exceptions to the posted security requirement in NRS 108.2405(1):

The provisions of NRS 108.2403 and 108.2407 do not apply:

- (a) *In a county with a population of 700,000 or more with respect to ... a ground lease for real property which is designated ... by the county for commercial purposes which are compatible with the operation of the international airport*
- (b) *If all owners of the property ... record a ... notice of waiver of the owners' rights [to record a notice of non-responsibility] ... before the commencement of construction of the work of improvement.*

The first exception is a favorite trick of the Nevada Legislature: making an exception based on a specific population count in the applicable county. In this case, there is a carve-out for properties that are located in a county with a population of 700,000 or more (only Clark County), where a ground lessee enters into a 10-year or more ground lease, for property that has been designated for commercial uses compatible with an international airport located in the same county (Clark and Washoe). Thus, this exception only applies to commercial properties located in or around McCarran Airport in Las Vegas. Other long-term ground leases are not exempted and require posted security.

The second exception is to make the lessor's interest in the property being improved subject to mechanic's liens arising from the tenant improvement. This is not usually acceptable to lessors or their lenders, so obtaining this waiver can be difficult. This also reveals the underlying basis for the posted security requirement: to protect contactor's payment rights and their ability to fall back on the mechanic's lien remedy when payment is not made.

In summary, the need to provide posted security for a tenant improvement should not be overlooked or disregarded by real estate lawyers setting up tenant leases. **NL**

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LEON MEAD'S biography is on page 10.

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