NEWSLETTER OF THE REAL PROPERTY SECTION OF THE MISSISSIPPI BAR

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RECENT CASES

Stop Notice Procedure for Subcontractors is Unconstitutional

Noatex Corp. v. King Construction of Houston, Inc., 732 F.3d 479 (5th Cir. 2013). Auto Parts Manufacturing Mississippi ("Owner"), signed a construction contract with Noatex Corporation ("Noatex'), as general contractor, for construction of improvements on the Owner's land in Guntown, Mississippi. Noatex entered into a contract with King Construction Company ("King"), to provide materials and labor to the job. A disagreement about payments arose between Noatex and King. Pursuant to Mississippi's stop notice statute, Miss. Code Ann. § 85-7-181, and Section 85-7-197, which authorizes a subcontractor to file a notice of lien in the land records, King filed a "Laborer's and Materialmen's Lien and Stop Notice" in the land records in the office of the Chancery Clerk of Lee County claiming that Noatex owed King $260,410, and served a copy on the Owner. Things quickly escalated: Noatex filed a declaratory judgment action in the federal district court for the Northern District of Mississippi seeking a declaratory judgment that Mississippi's stop notice statute was unconstitutional, and the State of Mississippi intervened in this action to defend the constitutionality of the statute; the Owner interpled the amount at issue claimed by King into the Chancery Court of Lee County, and Noatex removed the interpleader action to the federal court; and Noatex filed an action in the federal district court against King for breach of contract and seeking damages in excess of $500,000. All of the lawsuits were consolidated in the federal

district court for the Northern District of Mississippi. Noatex filed a motion for summary judgment challenging the constitutionality of the stop notice statute. Noatex argued that the service of the stop notice by King deprived Noatex of a significant property interest without due process of law, and that the stop notice process was similar to Mississippi's pre-judgment attachment statutes that have been declared to be unconstitutional. King and the Attorney General argued that the stop notice statute did not deprive the contractor of any property interest, but only created a lien, and therefore was more like a contractor's lien than a pre-judgment attachment. On April 12, 2012, the federal district court granted Noatex's motion for summary judgment and held that the stop notice statute was unconstitutional. The district court wrote that the stop notice statute violated due process "by authorizing what is in practical effect the pre-judgment attachment of funds without prior notice and a hearing, or post-seizure remedy." 864 F. Supp.2d 478, 490 (N.D. Miss. 2012). On appeal by the State of Mississippi, the Fifth Circuit affirmed the district court's decision on October 10, 2013.

Note 1: In Mississippi, unlike many states, subcontractors do not have liens. This has been an extremely contentious subject between subcontractors, on the one hand, who want a lien, and contractors and construction lenders, who oppose a subcontractor's lien, on the other hand.

Note 2: Doesn't this case leave subcontractors without any effective remedy for non-payment by contractors? The subcontractor may still have an action against the contractor for breach of contract, but surely no one can say with a straight face that this is an effective remedy in the real world. One of the Attorney General's arguments in the district court was that "Mississippi state and federal courts have repeatedly upheld the stop notice procedure as the only remedy for subcontractors seeking recovery for provided labor and materials." 864 F. Supp.2d at 486. The district court wrote that without the stop notice, "materialmen and laborers would be mere general creditors of the contractor." *Id*. at 488-89 (quoting from *Chic Creations of Bonita Lakes Mall v. Doleac Elec. Co.*, 791 So.2d 254, 259 (Miss. 2000)).

Note 3: Legislation is being prepared for the 2014 session of the legislature to address this case. One proposal will be to give subcontractors a lien similar to the statutory lien for contractors. Subcontractors were successful in getting Section 85-7-185 amended in 2012 to provide that performance bonds cover amounts due to subcontractors, and in getting Section 85-7-181 amended in 2010 to extend to rental equipment suppliers. But a subcontractors lien would be strongly opposed by construction lenders and general contractors, both of whom also have great influence in the legislature. Another proposal is anticipated to be a summary proceeding in court that would be intended to meet due process requirements described in the *Noatex* case. An article in the January 6, 2014 edition of the *Clarion-Ledger* identified this as one of the hot topics in the 2014 legislative session.

Note 4: Section 85-7-181 provides that if the owner pays the contractor after getting a stop notice, the subcontractor shall be entitled to a judgment against the owner, and the judgment shall be a lien from the date of the original notice. This lien only arises after judgment is obtained. The courts have interpreted this lien to apply only to money in the hands of the owner. Section 85-7-191 permits subcontractors to file notices of their claim

in the land records and obtain priority over third parties. If the stop notice procedure is unconstitutional, then presumably subcontractors can no longer claim the benefit of this lien.

Note 5: After the briefing in the Fifth Circuit had been completed, apparently, the Attorney General wrote a letter to the court asserting that Noatex had no standing to bring its action challenging the constitutionality of the stop-notice statute because Noatex had not obtained a certificate of responsibility for this project. A construction contract is void unless the contractor has obtained a certificate of responsibility from the State Board of Contractors. Miss. Code Ann. § 31-3-15. The Fifth Circuit wrote that the state waived this argument by not briefing it. The court also distinguished the effect of this statute on an action to enforce a construction contract and an action to assert constitutional claims. Section 31-3-15 may keep a contractor from bringing an action to enforce a construction contract, but the contractor can still assert constitutional claims even if he does not have a certificate of responsibility.

Note 6: Subcontractor's liens would pose a new risk for title insurance companies in construction loans. Contractors' liens already are a major source of claims on title insurance policies, and the addition of a lien for subcontractors likely would increase these claims exponentially. Presumably this increase in claims would be followed by a corresponding increase in premiums or limitation on coverage. Title insurance agents disbursing construction funds would have to get lien waivers from all subcontractors as well as contractors. One problem is that many subcontracts are informal. Typically there are many more subcontractors than contractors, which would increase the agent's work and risk.

Amendments to Lease made CPI provision ambiguous

Enniss Family Realty I, LLC v. Schneider National Carriers, Inc., United States District Court for the Southern District of Mississippi, 2013 WL 2468864 (June 7, 2013). In 1999 Anika & Associates ("Anika"), as landlord, and Schneider National Carriers, Inc.("Schneider") as tenant, entered into a lease for a 17,000 square foot warehouse space in Brandon, Mississippi. The lease had a twenty-year term with a base rent of $11,758. The lease provided that the rent was to be adjusted for increases in the Consumer Price Index ("CPI") after the fifth, tenth and fifteenth years. In 2004 the rent was increased to $13,170 to reflect changes in the CPI from 1999, without any issue. On July 24, 2006, in connection with an expansion of the building, Anika and Schneider amended the lease to increase the size of the building to 50,000 square feet and to increase the rent to $38,750 per year beginning the later of November 1, 2006 or the date that the building was completed. On October 25, 2006, Anika and Schneider amended the lease again to extend the term to 2027, changed the date that the increased base rent would begin to the later of April 2007 or the date that Schneider took possession. Schneider took possession of the new premises on April 24, 2007. In May 2007, Enniss Family Realty I, LLC ("Enniss") purchased the property from Anika, and Anika assigned its interest as landlord under the lease to Enniss. The problems began with the CPI adjustment scheduled for 2009. In its calculations of the CPI adjustment, Enniss used the entire 50,000 square feet of floor

space and the increased amount of base rent in its calculations of the CPI adjustment. Schneider took the position that the new space that became part of the Premises was not subject to the CPI adjustment until 2012, five years after Schneider took possession. In the course of negotiations, both parties changed their positions as to the amount of the rent that was due. The parties were unable to reach an agreement, so in November 2011, Enniss filed an action in the Chancery Court of Rankin County and requested a declaratory judgment regarding the amount of the rent. Schneider removed this action to the United States District Court for the Southern District of Mississippi, where it was assigned to Judge Starrett. Enniss filed a motion for summary judgment that as a matter of law the lease required Schneider to pay a monthly rent of $49,807.82. Schneider argued that the lease required monthly rent of only $41,895.42. The court found that the lease was ambiguous, denied the motion for summary judgment, and set the case for trial. 916 F. Supp. 2d 702. Following the trial, the court issued its Memorandum Opinion on June 7, 2013 addressing the merits of this case. The court found the CPI provision was ambiguous. In part the court found that the parties' multiple interpretations of the lease showed that the lease was ambiguous. The court looked to the purpose of the CPI clause, which all parties agreed was to neutralize the effect of inflation. Enniss's calculation of the CPI adjustment increased the rent 28.5% between 2007 and 2009, when inflation was only 4.7%. On the other hand, one of Schneider's calculations resulted in increases in rent that largely tracked the rate of inflation. The court held that the rent should be $41,895.42 figure, the amount asserted by Schneider.

Note 1: This case has not been published yet, but hopefully will be. Judge Starrett's lengthy opinion is addresses many topics of Mississippi leasing law, and would be worthwhile reading for anyone who drafts leases or litigates lease issues in Mississippi.

Note 2: CPI clauses are notoriously difficult to get right under any circumstances. An initial issue is determining the right CPI index. For example, there is a CPI-U, which covers all urban consumers, and a CPI-W, which only covers urban wage earners and clerical workers. The Bureau of Labor Statistics has a webpage on the CPI at www.bls.gov/cpi. According to the website, "Price indexes are available for the U.S., the four Census regions, size of city, cross-classifications of regions and size-classes, and for 26 local area. Indexes are available for major groups of consumer expenditures (food and beverages, housing, apparel, transportation, medical care, recreation, education and communications, and other goods and services), for items within each group, and for special categories, such as services." If you are drafting a CPI clause, one experienced leasing attorney has recommended having someone else who has not been involved in the drafting to read through the clause and make the calculation to make sure that the formula works.

Note 3: While the case focuses on the CPI clause, the editor sees this case as a broader cautionary tale about amendments to leases. In this case the CPI clause worked as written in the original lease, but the calculation became problematic that after the parties amended the term and premises. The clause simply did not address the changes to the leased premises and the term. There were other inconsistencies between the original lease and the amendments. One point that Judge Starrett notes in his opinion is that the defined terms in the 2006 amendments did not match the defined terms in the original

lease. For example, the original lease used the term "Beginning Rent", and the amendments used the term "Base Rent". Citing several Mississippi cases, the opinion states, 'The existence of inconsistent contract provisions is a well-recognized basis for ambiguity under Mississippi law."

Note 4: The fact that the parties kept changing their positions about how the rent should be calculated clearly made an impression on the court. For example, at one point the opinion reads, "Schneider has changed positions as to the "correct" contract interpretation prior to trial *and* during the course of the litigation. As noted above, Schneider's position as late as the submission of the Pretrial Order was that the interpretation resulting in monthly rental amount of $41,895.42 was correct. However, Schneider's corporate representative, Steve Parent, testified at trial that "$40,688 is the proper number to be paid [citations to trial transcript omitted.] Schneider's flip-flopping weighs against any finding that the pertinent portions of the Agreement are clear and unambiguous." Also, the court noted the fact that both parties sought legal counsel to interpret the lease. The court wrote, "Upon review of the totality of Mr. Parent's testimony and the correspondence exchanged between between Ennis and Schneider early in their dispute, it appears that both of these figures were derived through consultation with legal counsel given the lack of clarity in the parties' Agreement as to how to calculate CPI adjustments following the execution of the Lease Amendments." To paraphrase the opinion: how can you say that the CPI clause is not ambiguous when you both changed your position at least three times and sought legal advice about what the clause meant?

Determining Fair Market Value by Appraisal(s)

Crow v. Crow's Sports Center, Inc., 119 So. 3d 352 (Miss. Ct. App. 2013). Sylvester and Martha Crow leased a shopping center to Lynn and Rhonda Lambert and others (collectively "Lamberts"). The lease was drafted by the Crows' attorney. The lease included an option to purchase on the death of either of Sylvester or Martha. The option provided in relevant part that the Lamberts "shall have the option to purchase said property for a fair market value as determined by appraisal by a licensed real appraiser." The lease also required the Lamberts to submit proof of the appraisal and proof of the Lamberts' ability to pay. Sylvester passed away in April 2005. Pursuant to the terms of the lease, the Lamberts gave notice to Martha Crow of their intent to exercise the option to purchase, together with an appraisal that showed a value of $47,000 and proof of available funds to purchase for that amount. Martha Crow had the property appraised by two other appraisers. One of Crow's appraisals showed a value of $110,000 and the other showed a value of $105,000. Crow refused to sell to the Lamberts for $47,000. The Lamberts brought an action for specific performance of the option in the Chancery Court of Prentiss County. Crow argued that the option to purchase was unenforceable because it did not state a purchase price. The chancellor held that the option was enforceable, that the Lamberts had met the requirements of the lease, and that the Lamberts were entitled to specific performance. The chancellor found that the Lamberts' appraisal met the requirements of the lease and refused to allow the other appraisals into evidence. On appeal by Crow, the Mississippi Court of Appeals, in a split decision, reversed and remanded. Justice Lee wrote the majority opinion that was joined by two justices. Three

justices concurred in the result without a separate opinion. The first issue addressed in the majority opinion was whether the option to purchase was enforceable. Justice Lee wrote that in order to be enforceable, the option had to state a purchase price or a method of determining the purchase price. In this case, the lease provided a sufficient method of determining the purchase price because it required an appraisal by a licensed appraiser. But, secondly, according to the majority opinion, "the chancellor did not follow the property method of determining the purchase price." The majority opinion states that the chancellor erred by only considering the appraisal submitted by the Lamberts and not the other two appraisals obtained by Crow. The court held that the case should be remanded, the chancellor should obtain an independent appraisal, and then conduct a hearing to determine the fair market value, with both parties having the opportunity to submit evidence. The four justices who concurred in part and dissented in part, in a opinion by Justice Russell, concurred with the majority's opinion that the option was enforceable. However, wrote Judge Russell, the lease was unambiguous that the method for determining the value was by appraisal submitted by the Lamberts, the Lamberts complied with the terms of the lease, and so the chancellor's order granting specific performance should be enforced.

Note 1: In the editor's humble opinion, the chancellor and the dissenting opinion made the correct analysis, and the majority opinion got it wrong. It does not even seem like a close question. The lease provided that the Lamberts were to provide the appraisal, and they did so. The lease could have provided that if Crow did not agree with the value, then Crow could get her own appraisal, and the value would be the average of the two appraisals, or any of the myriad of alternatives available to protect an optionor against a low-ball appraisal. But the lease did not do so. That is why the chancellor did not take the other appraisals into account in determining the sales price. The Lamberts complied with the terms of the lease, and their option should have been enforced.

Note 2: The editor sees this case as another cautionary tale about drafting. Stating that the value would be determined by appraisal may sound reasonable in theory, but anyone with experience knows that one could hire a dozen appraisers who would come up with a dozen different conclusions about the value.

Note 3: The majority opinion states, "One would think that qualified licensed professionals would not be so far apart on the valuation of property. Otherwise, the implication is that the appraisers have submitted appraisals that favor their respective clients, as opposed to a true fair market valuation." So to avoid this implication, the majority's solution is to require the chancellor to get a fourth "independent" appraisal that the parties have to pay for? This solution seems to confirm the implication is correct, and create unnecessary expense and delay. Why not allow the chancellor to hear evidence about the three existing appraisals, including cross-examination of the appraisers, and then decide which of these most represents the fair market value?

Note 4: This case makes an interesting comparison with the *Enniss* case discussed above on one point. In *Enniss*, Judge Starrett considered whether ambiguities in the lease should be construed against the party that drafted it, and determined that this canon of construction was not appropriate since both parties were sophisticated and had equal bargaining power. In *Crow*, the attorney for the landlord prepared the lease. If the lease

was not clear on the method of determining the value, why shouldn't the *Crow* lease be construed against the landlord on this point?

Note 5: The fact that less than a majority of the justices of the Court of Appeals in this *en banc* decision joined the majority opinion suggests that the other justices also were not comfortable with the majority's reasoning. The majority opinion was joined by two justices; three justices concurred with the majority opinion in part and with the result but did not write a separate opinion; and four justices concurred in holding that the option was enforceable but would have affirmed the chancellor's order enforcing the option. Where does this leave us as far as the precedential value of this case? The editor's reading is that the court's disposition of the first issue—whether the option was enforceable—does have precedential value, but that the value as precedent of the court's disposition of the second issue-whether the chancellor should have considered evidence of value other than the appraisal submitted by the Lamberts—is open to challenge.

FIFTH CIRCUIT CASES OF INTEREST FROM OTHER STATES

Homeowners association not entitled to compensation when units taken

United States v. 0.073 Acres of Land, 705 F.3d 540 (5th Cir. 2013). This is a case of first impression in the Fifth Circuit. Mariner's Cove Townhomes was a 58-unit townhome development in New Orleans. The development was subject to a declaration that entitled the homeowners' association ("HOA") to impose assessments against the owners and required the association to provide services such as maintaining streets within the development and removing trash. After Hurricane Katrina, the Corps of Engineers determined that it needed to acquire fourteen of the townhome units in Mariner's Cove in order to make repairs to a levee. The United States initiated condemnation actions against the owners of the fourteen units, and also named the homeowners association as a party. The government reached settlements with the owners of the fourteen townhomes, but not with the HOA. The HOA argued that it was entitled to compensation because its assessment base was reduced by the taking of the fourteen townhomes. The government argued that any loss to the HOA was merely incidental to the taking of the townhomes and that the HOA was not entitled to any compensation. The district court granted the government's motion for summary judgment. On appeal, the Fifth Circuit affirmed. The Fifth Amendment of the United States Constitution provides that private property cannot be taken for public use without just compensation. The Fifth Circuit found that, under Louisiana law, the homeowners' association's right to collect assessments was an interest in real property, equivalent to a real covenant under the common law. But this HOA was not entitled to compensation in the eminent domain proceeding because of the collateral loss rule. Under the collateral loss rule, an owner of land is entitled to recover for the value of his land that is taken, but not for losses to his business or other collateral damage. The Fifth Circuit found that the HOA's right to collect assessments was more like a service contract than an interest in land, and that the HOA therefore was not entitled to any compensation under the Fifth Amendment for the reduction in its assessment base.

Note 1: Since this was case of first impression in Louisiana and the Fifth Circuit, the court looked at cases from other jurisdictions, and relied heavily on a treatise, *Nichols on Eminent Domain*. The majority view is that the owners of real covenants are entitled to compensation. The Fifth Circuit decided to follow the minority rule of not compensating for taking these types of covenant interests for two reasons. First, private parties should not, by their contracts, unduly burden the government's ability to exercise eminent domain. Second, the right to impose assessments, while a real covenant that ran with the land, was intangible and not an interest in the land itself.

Note 2: The HOA relied on a case from the Ninth Circuit, *Adaman Mutual Water Co. v. United States*, 278 F.2d 842 (9th Cir. 1960). In that case farmers owned stock in an association that in turn owned water and pumping equipment. The association had a lien on the land and water rights. When the United States brought an eminent domain action and took part of the land, the Ninth Circuit held that "under the Fifth Amendment a restrictive covenant imposing a duty which runs with the land constitutes a compensable interest." The Fifth Circuit distinguished *Adaman* on the basis that in *Adaman* the association owned a "natural resource that was directly connected to the physical substance of the land in that it physically inhered in the land itself." The Mariners Cove HOA, on the other hand, did not have a direct interest in the land, but only provided services.

Note 3: This case has received much scholarly attention, mostly critical, for its finding that the HOA had a real property interest, but not a compensable real property interest. A petition for certiorari was filed with the United States Supreme Court based on the split in the circuits on this issue, and also based on the argument that the decision is inconsistent with the Supreme Court's recent decision in *Koontz v. St. John's River Water Management District*, 133 S. Ct. 2586 (2013). In a brief in support of the petition, the Cato Institute made the argument, among others, that under the *Mariners Cove* case, the taking of a conservation easement would not be compensable. The Supreme Court, however, denied certiorari.

Ordinance Requiring Proof of Citizenship of Residential Renters is Unconstitutional

Villas at Parkside Partners v. City of Farmers Branch, 726 F.3d 524 (5th Cir. 2013). This is another case of first impression in the Fifth Circuit. The City of Farmers Branch, Texas enacted an ordinance requiring individuals to obtain a license before occupying a rented apartment. If a renter was not a citizen of the United States, the license could be revoked. Landlords also were prohibited from renting an apartment without obtaining a license from the occupants, and were required to include in their leases a provision that occupancy by a person without a license would be a default. Landlords and tenants brought an action in the United States District Court for the Northern District of Texas challenging the constitutionality of the ordinance. The district court granted summary judgment to the plaintiffs. The Fifth Circuit *en banc* affirmed on the grounds that the ordinance was preempted by federal immigration laws. The court was, to put it mildly, split. Judge Higginson authoried the majority opinion, in which he wrote, among other things, "The Farmers Branch ordinance is but one example of a trend in this country of

states and localities attempting to take immigration matters into their own hands. This trend to single out illegal immigrants for adverse treatment is reminiscent of the "anti-Japanese fever" that existed in the 1940s." No other judges joined this opinion, but five other judges concurred in three separate opinions, while five judges dissented in a strident opinion by Judges Jones and Elrod. The opinion is sixty-two pages.

Note 1: The City of Farmers Branch has filed a petition for writ of certiorari with the United States Supreme Court (Oct. 24, 2013, No. 13-516). As of January 7, 2014, briefs have been filed but the Supreme Court has not yet determined whether to grant or deny the petition.

Note 2: This issue also has been addressed recently in other circuits. *See Lozano v. City of Hazelton*, 724 F. 3d 297 (3d Cir. 2013) (petition for certiorari filed Oct. 24, 2013, No. 13-531) (city ordinance prohibiting renting to illegal aliens is pre-empted by federal immigration law); *Keller v. City of Fremont*, 719 F. 3d 931 (8th Cir. 2013) (city ordinance prohibiting renting to illegal aliens is not pre-empted by federal immigration law).