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*Full-size, fillable copies of all 350+ first tuesday forms can be found in the Forms-on-CD accompanying this course.*
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Introduction

Landlords, Tenants and Property Management is written for real estate licensees, landlords, property managers, attorneys and investors. The course material is designed to be an educational tool for use in the classroom and in correspondence studies as well as a strong technical research and reference tool.

The objective of Landlords, Tenants and Property Management is to inform the reader of federal, state and local landlord/tenant rights and obligations. This book examines the exacting rules of leasing and renting both residential and nonresidential income properties. Also included are examples that vividly present and resolve landlord/tenant situations encountered by owners and real estate licensees who manage income property or perform services as leasing agents.

A distinction exists between nonresidential (commercial, industrial, etc.) and residential landlord-tenant relationships. This distinction lies in the residential rental exception carved out of the general, long-standing landlord-tenant rules once applicable to both residential and nonresidential property. General landlord-tenant rules apply fully to nonresidential leasing arrangements and, to the extent not overridden by extensive residential exceptions, apply to residential leasing arrangements as well.

Included in each chapter is a summary of issues reviewed in the chapter with definitions of the key terms essential to the reader’s comprehension of the topic. Unless a form cited in the book says, “See Form XXX accompanying this chapter” [emphasis added], it is not in the book. However, the reader has access to a fillable and savable version of all referenced first tuesday forms on the first tuesday Forms-on-CD delivered with the course enrollment package. The CD contains 400+ first tuesday real estate forms, plus a digital version of our library of the sixteen volumes comprising the first tuesday Realtipedia publication.

All materials are also accessible online from the reader’s Student Homepage at www.firsttuesday.us during their one-year enrollment period.

Future errata, supplemental material and recent developments specific to Landlords, Tenants and Property Management are available for further research within the Online Reading section of the reader’s Student Homepage at www.firsttuesday.us.
Chapter 1: Fee vs. leasehold

Fee vs. leasehold

After reading this chapter, you will be able to:

- identify the different possessory interests held in real estate, and the rights and obligations associated with each;
- distinguish the individual rights which collectively comprise real property;
- identify the different types of leasehold interests held by tenants;
- understand leasehold interests which convey special rights, such as a ground lease, master lease or sublease.

Real estate, sometimes legally called real property or realty, consists of:

- the land;
- the improvements and fixtures attached to the land; and
- all rights incidental or belonging to the property.\(^1\)

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\(^1\) Calif. Civil Code §662
A parcel of real estate is located by circumscribing its legal description on the “face of the earth.” Based on the legal description, a surveyor locates and sets the corners and surface boundaries of the parcel. The legal description is contained in deeds, subdivision maps or government surveys relating to the property.

All permanent structures, crops and timber are part of the parcel of real estate. The parcel of real estate also includes buildings, fences, trees, watercourses and easements within the parcel’s boundaries.

A parcel of real estate is three dimensional. In addition to the surface area within the boundaries, a parcel of real estate consists of:

- the soil below the parcel’s surface to the core of the earth, including water and minerals; and
- the air space above it to infinity.

For instance, the rental of a boat slip includes the water and the land below it. Both the water and land below the boat slip comprise the real estate, the parcel leased. Thus, landlord/tenant law controls the rental of the slip.

In the case of a statutory condominium unit, the air space enclosed within the walls is the real estate conveyed and held by the fee owner of the unit. The structure, land and air space outside the unit are the property of the homeowners’ association (HOA).

The ownership interests a person may hold in real estate are called estates. Four types of estates exist in real estate:

- fee estates, also known as fee simple estates, inheritance estates, perpetual estates, or simply, the fee;
- life estates;
- leasehold estates, sometimes called leaseholds, or estates for years; and
- estates at will, also known as tenancies-at-will.

In practice, these estates are separated into three categories: fee estates, life estates and leasehold estates. Estates at will are considered part of the leasehold estates category. Leasehold estates are controlled by landlord/tenant law.

A person who holds a fee estate interest in real estate is a fee owner. In a landlord/tenant context, the fee owner is the landlord.

Editor’s note — If a sublease exists on a nonresidential property, the master tenant is the “landlord” of the subtenant.

A fee owner has the right to possess and control their property indefinitely. A fee owner’s possession is exclusive and absolute. Thus, the owner has the

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2 CC §761
right to deny others permission to cross their boundaries. No one can be on
the owner’s property without their consent, otherwise they are trespassing. The owner may recover any money losses caused by the trespass.

A fee owner has the exclusive right to use and enjoy the property. As long as
local ordinances such as building codes and zoning regulations are obeyed, a
fee owner may do as they please with their property. A fee owner may build
new buildings, tear down old ones, plant trees and shrubs, grow crops or
simply leave the property unattended.

A fee owner may occupy, sell, lease or encumber their parcel of real estate,
give it away or pass it on to anyone they choose on their death. The fee estate
is the interest in real estate transferred in a real estate sales transaction, unless
a lesser interest such as an easement or life estate is noted. However, one
cannot transfer an interest greater than they received.

A fee owner is entitled to the land’s surface and anything permanently
located above or below it.3

The ownership interests in one parcel may be separated into several fee
interests. One person may own the mineral rights beneath the surface,
another may own the surface rights, and yet another may own the rights
to the air space. Each solely owned interest is held in fee in the same parcel.
[See Case in point, “Separation of fee interests”]

In most cases, one or more individuals own the entire fee and lease the
rights to extract underground oil or minerals to others. Thus, a fee owner
can convey a leasehold estate in the oil and minerals while retaining their
fee interest. The drilling rights separated from the fee ownership are called
profit a prendre.4

Profit a prendre is the right to remove profitable materials from property
owned and possessed by another. If the profit a prendre is created by a lease
agreement, it is a type of easement.5

3 CC §829
4 Rousselot v. Spanier (1976) 60 C3d 238
5 Gerhard v. Stephens (1968) 68 C2d 864
A **life estate** is an interest in a parcel of real estate lasting the lifetime of an individual, usually the life of the tenant. *Life estates* are granted by a deed entered into by the fee owner, an executor under a will or by a trustee under an inter vivos trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for another person (the life tenant) during that person’s lifetime, called the controlling life.

Life estates terminate on the death of the controlling life. Life estates may also be terminated by agreement or by merger of different ownership interests in the property.

For example, the fee owner of a vacation home has an elderly aunt who needs a place to live. The fee owner grants her a life estate in the vacation home for the duration of her lifetime. The aunt may live there for the rest of her life, even if she outlives the fee owner who granted her the life estate.

Although the aunt has the right of exclusive possession of the entire parcel of real estate, the fee owner retains title to the fee estate. Thus, the conveyance of a life estate transfers a right of possession which has been “carved out” of the fee estate. This is comparable to possession under a leasehold estate since it is conveyed for its duration out of a fee estate. Unlike a lease, a life estate does not require rent to be paid.

On the aunt’s death, possession of the property reverts to the fee owner, their successors or heirs. The right of possession under the life estate is extinguished on the aunt’s death.

The holder of a life estate based on their life has the right of possession until death, as though they were the owner in fee. The holder of a life estate is responsible for taxes, maintenance and a reasonable amount of property assessments.6

The holder of a life estate may not *impair* the fee interest.7

For instance, the holder of a life estate may not make alterations which decrease the property’s value, such as removing or failing to care for valuable plants or demolishing portions of the improvements or land.

Conversely, the owner of the life estate has the right to lease the property to others and collect and retain all rents produced by the property during the term of the life estate.

In addition, a life tenant is entitled to be reimbursed by the fee owner for the fee owner’s share of the costs to improve the property.

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6 CC §840
7 CC §818
Leasehold estates, or tenancies, are the result of rights conveyed to a tenant by a fee owner (or by the life estate tenant or master lessor) to possess a parcel of real estate.

Tenancies are created when the landlord and the tenant enter into a rental or lease agreement that conveys a possessory interest in the real estate to the tenant.

The tenant becomes the owner of a leasehold with the right to possess and use the entire property until the lease expires. The ownership and title to the fee interest in the property remains with the landlord throughout the term of the leasehold. The landlord’s fee interest is subject to the tenant’s right of possession, which is carved out of the fee on entering into the lease agreement.

In exchange for the right to occupy and use the property, the landlord is entitled to rental income from the tenant during the period of the tenancy.

Four types of leasehold estates exist and can be held by tenants. The interests are classified by the length of their term:

- A fixed-term tenancy, simply known as a lease and legally called an estate for years;
- A periodic tenancy, usually referred to as a rental;
- A tenancy-at-will, previously introduced as an estate at will; and
- A tenancy-at-sufferance, commonly called a holdover tenancy.

A fixed-term tenancy lasts for a specific length of time as stated in a lease agreement entered into by a landlord and tenant. On expiration of the lease term, the tenant’s right of possession automatically terminates unless it is extended or renewed by another agreement, such as an option agreement. [See Figure 1, Form 552 §2]

Periodic tenancies also last for a specific length of time, such as a week, month or year. Under a periodic tenancy, the landlord and tenant agree to automatic successive rental periods of the same length of time, such as in a month-to-month tenancy, until terminated by notice by either the landlord or the tenant.

In a tenancy-at-will (also known as an estate at will) the tenant has the right to possess a property with the consent of the fee owner. Tenancies-at-will can be terminated at any time by an advance notice from either the landlord or the tenant or as set by agreement. Tenancies-at-will do not have a fixed duration, are usually not in writing and a rent obligation generally does not exist.

A tenancy-at-sufferance occurs when a tenant retains possession of the rented premises after the tenancy granted terminates. [See Chapter 2]
Leaseholds conveying special uses

In addition to the typical residential and nonresidential leases, you will find special use leases.

*Oil, gas, water* and *mineral leases* convey the right to use mineral deposits below the earth’s surface.

The purpose of an oil lease is to discover and produce oil or gas. The lease is a tool used by the fee owner of the property to develop and realize the wealth of the land. The tenant provides the money and machinery for exploration, development and operations.

The tenant pays the landlord rent, called a *royalty*. The tenant then keeps any profits from the sale of oil or minerals the tenant extracts from beneath the surface of the parcel.

A *ground lease* on a parcel of real estate is granted to a tenant in exchange for the payment of rent. In a *ground lease*, rent is based on the rental value of the land in the parcel, whether the parcel is vacant or improved. Fee owners of vacant, unimproved land use leases to induce others to acquire an interest in the property and develop it.

*Ground leases* are common in more densely populated areas. Developers often need financial assistance from fee owners to avoid massive cash outlays to acquire unimproved parcels. Also, fee owners of developable property often refuse to sell, choosing to become landlords for the long-term rental income they will receive.

An original tenant under a ground lease constructs their own improvements. Typically, the tenant encumbers their possessory interest in a ground lease with a trust deed lien to provide security for a construction loan.

A *master lease* benefits fee owners who want the financial advantages of renting fully improved property, but do not want the day-to-day obligations and risks of managing the property.

For instance, the fee owner of a shopping center and a prospective owner-operator agree to a master lease.
As the master tenant, the owner-operator will collect rent from the many subtenants, address their needs and maintain the property. The master tenant is responsible for the rent due the fee owner under the master lease, even if the subtenants do not pay their rents to the master tenant.

The master lease is sometimes called a sandwich lease since the master tenant is “sandwiched” between the fee owner (the landlord on the master lease) and the many subtenants with their possession under subleases.

The master lease is a regular, nonresidential lease agreement form with the clauses prohibiting subletting removed. A sublease is also a regular, nonresidential lease agreement with an additional clause referencing the attached master lease and declaring the sublease subject to the terms of the master lease. [See first tuesday Form 552 §2.5]

Another type of special-use lease is the farm lease, sometimes called a cropping agreement or grazing lease. Here, the tenant operates the farm and pays the landlord either a flat fee rent, a percentage of the value of the crops or livestock produced on the land.

Editor’s note — For simplicity, the remainder of the book will treat the landlord as the fee owner, unless a sublease is specifically referenced. Fee owners will be referred to as “landlords,” or, if a distinction is required, simply as “owners.”

The ownership interests a person may hold in real estate are called estates. Four types of estates exist in real estate:
- fee estates;
- life estates;
- leasehold estates; and
- estates at will.

In practice, estates at will are considered leasehold estates. Leasehold estates are controlled by landlord/tenant law.

Four types of leasehold interests exist and can be held by tenants:
- fixed-term tenancies;
- periodic tenancies;
- tenancies-at-will; and
- tenancies-at-sufferance.
A fixed-term tenancy lasts for a specific length of time as stated in a lease agreement entered into by a landlord and tenant. On expiration of the lease term, the tenant’s right of possession automatically terminates unless it is extended or renewed by another agreement.

Periodic tenancies last for a specific length of time. Under a periodic tenancy, the landlord and tenant agree to automatic successive rental periods of the same length of time, such as in a month-to-month tenancy, until terminated by notice by either the landlord or the tenant.

Under a tenancy-at-will, the tenant has the right to possess a property with the consent of the fee owner. Tenancies-at-will can be terminated at any time by an advance notice from either the landlord or the tenant or as set by agreement. Tenancies-at-will do not have a fixed duration.

A tenancy-at-sufferance occurs when a tenant retains possession of the rented premises after the tenancy granted terminates.

In addition, several special use leases exist, including ground leases, master leases and subleases.
A landlord and tenant enter into a lease agreement. The lease agreement does not include an option to renew or extend the term of the occupancy on expiration of the lease.

Several months before the lease expires, they begin negotiations to enter into a modified or new lease agreement to extend the term of occupancy. The landlord and tenant do not reach an agreement before the lease expires. On expiration of the lease, the tenant remains in possession of the property.

The landlord and tenant continue lease negotiations. Meanwhile, the landlord accepts monthly rent at the same rate the tenant paid under the expired lease agreement.
Ultimately, they fail to agree on the terms for an extension or a new lease agreement. The landlord serves a notice on the tenant to either stay and pay a substantially higher monthly rent, or vacate and forfeit the right of possession. [See first tuesday Form 571; see Form 569 in Chapter 23]

The tenant does neither. The tenant remains in possession on expiration of the notice, but does not pay the increased rent.

Can the landlord evict the tenant by filing an unlawful detainer (UD) action on expiration of the notice?

Yes! The tenant’s right of possession went from an initial fixed-term tenancy to a tenancy-at-sufferance when the lease expired. When the landlord accepted rent for the continued occupancy, the tenancy-at-sufferance became a periodic tenancy. The tenant’s failure to pay the higher rent demanded in the notice terminated the tenant’s right of possession under the periodic tenancy on expiration of the notice to pay rent or quit.

Different types of tenancies and properties trigger different termination procedures for the landlord, and different rights for the tenant. [See Chapters 20, 30 and 35]

Recall from Chapter 1 that leasehold estates, or tenancies, are possessory interests in real estate. Four types of tenancies exist:

- fixed-term tenancies;
- periodic tenancies;
- tenancies-at-will; and
- tenancies-at-sufferance, also called holdover tenancies.

To initially establish a tenancy, a landlord needs to transfer to the tenant the right to occupy the real estate. This right is conveyed either orally, in writing or by the landlord’s conduct, called a grant. If the landlord does not transfer the right to occupy, the person who takes possession as the occupant is a trespasser.

Fixed-term tenancies, periodic tenancies and tenancies at will have agreed-to termination dates, or can be terminated by notice.

A holdover tenancy occurs when a tenant unlawfully continues in possession of the property after their right to occupy has expired. This unlawful possession of the property without contractual right is called unlawful detainer (UD).

A landlord needs to file a UD action in court to evict a holdover tenant. A tenant’s right of possession under the tenancy is terminated either by service of the proper notice or expiration of the lease before he can be evicted. Plainly speaking, the tenant needs to unlawfully detain possession of the property before the tenant can be evicted for unlawful detainer.
Since the type of notice required to terminate a tenancy depends on the period of the tenancy, period of the occupancy and location of the property (e.g., rent control), landlords and property managers need to understand how each type of tenancy is created.  

A fixed-term tenancy, also called a lease or estate for years, is the result of an agreement between the landlord and the tenant for a fixed rental period. If the rental period is longer than one year, the lease arrangements need to be in writing and signed by the landlord and tenant to be enforceable. The written document which sets the terms of a fixed-term tenancy is called a lease agreement. A lease agreement has a commencement date and an expiration date.  

During the term of the lease, the tenancy can only be terminated and the tenant evicted for cause. Even then, service of a three-day notice to cure the breach or vacate the property is required.  

Without an exercise of a renewal or extension option, a fixed-term tenancy automatically terminates on the expiration date, no notice required.  

If a renewal or extension option exists, the lease is renewed or extended by the tenant’s exercise of the option or the landlord’s acceptance of rent called for in the option.  

A fixed-term tenancy provides a tenant with several advantages:  

- the right to occupy for the fixed term;  
- a predetermined rental amount; and  
- limitations on termination or modification.  

**Case in point**  
Second lease term is not a periodic tenancy

A landlord and tenant orally agree to a six-month lease, with rent payable monthly. At the end of six months, the landlord and tenant orally agree to another six-month lease.  

At the end of the second term, the tenant refuses to vacate, claiming the landlord needs to first serve them with a notice to vacate.  

Here, the tenant is not entitled to any further notice beyond the agreed-to termination date. The oral occupancy agreement was not a periodic tenancy, even though it called for monthly rent payments. Instead, the occupancy agreement created a fixed-term lease with a set expiration date. Thus, the tenant’s right of possession terminated on expiration of the orally agreed-to six-month period. The oral lease agreement was enforceable since it was for a term of less than one year.  

A fixed-term tenancy, also called a lease or estate for years, is the result of an agreement between the landlord and the tenant for a fixed rental period. If the rental period is longer than one year, the lease arrangements need to be in writing and signed by the landlord and tenant to be enforceable. The written document which sets the terms of a fixed-term tenancy is called a lease agreement. A lease agreement has a commencement date and an expiration date.  

During the term of the lease, the tenancy can only be terminated and the tenant evicted for cause. Even then, service of a three-day notice to cure the breach or vacate the property is required. [See Form 576 in Chapter 21]  

Without an exercise of a renewal or extension option, a fixed-term tenancy automatically terminates on the expiration date, no notice required.  

If a renewal or extension option exists, the lease is renewed or extended by the tenant’s exercise of the option or the landlord’s acceptance of rent called for in the option. [See Case in point, “Second lease term is not a periodic tenancy”]  

A fixed-term tenancy provides a tenant with several advantages:  

- the right to occupy for the fixed term;  
- a predetermined rental amount; and  
- limitations on termination or modification.

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1 Colyear v. Tobriner (1936) 7 Cal. 735
2 CC §§761, 1624
3 CCP §1161(1)
4 CC §9145
However, a fixed-term tenancy also has disadvantages for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (less rent paid by any replacement tenant located by the landlord to mitigate his losses) [See Chapter 19]; and
- the tenant may not vacate prior to expiration of the rental period and assign or sublet the premises to a new tenant if prohibited by the lease agreement.

If the landlord finds a fixed-term tenancy too restrictive or inflexible for their requirements, a periodic tenancy may be more suitable.

A periodic tenancy automatically continues for equal, successive periods of time, such as a week or a month. The length of each successive period of time is determined by the interval between scheduled rental payments. A periodic tenancy is automatically renewed when the landlord accepts rent.

Examples of periodic payment intervals include:

- annual rental payments, indicating a year-to-year tenancy;
- monthly rental payments, indicating a month-to-month tenancy; and
- weekly rental payments, indicating a week-to-week tenancy.

A periodic tenancy is intentionally created by a landlord and tenant entering into a rental agreement. A rental agreement is the agreement which sets the terms of a periodic tenancy.

However, the tenancy can also arise due to a defective lease agreement. A tenant who enters into possession under an unenforceable lease agreement (e.g., oral, or unsigned) and pays rent in monthly intervals that the landlord accepts is a month-to-month tenant.

A periodic tenancy continues until terminated by a notice to vacate. This makes a periodic tenancy flexible, since it allows the landlord and the tenant to terminate a month-to-month tenancy by giving the appropriate notice to vacate to the other party.\(^5\) [See Forms 569 in Chapter 23 and 572 in Chapter 17]

To terminate a periodic tenancy, the notice period needs to be at least as long as the interval between scheduled rental payments, but need not exceed 30 days. An exception exists: a 60-day notice is required to terminate a residential periodic tenancy if the tenant has occupied the property for more than 12 months.\(^6\) [See Form 569-1 Chapter 23]

On a breach of the rental agreement, a three-day notice to vacate can also be used to terminate a periodic tenancy. [See Form 577 in Chapter 21]

The characteristics of a tenancy-at-will include:

- possession delivered to the tenant with the landlord’s knowledge and consent;

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\(^5\) Kingston v. Colburn (1956) 139 CA2d 623; CC §1946

\(^6\) CC §1946.1
Consider a property manager who rents an apartment to a tenant under a fixed-term lease. At the end of the leasing period, the tenant retains possession and continues to pay rent monthly, which the property manager accepts.

Later, the tenant is served with an appropriate notice to vacate. On the running of the notice period, the tenant refuses to vacate. The tenant claims the notice to vacate served by the landlord merely terminated the tenant’s right of possession and made it a tenancy-at-will on expiration of the notice. As a tenant-at-will, they are entitled to an additional three-day notice to vacate before they are unlawfully detaining the property.

However, an occupancy agreement for an indefinite term with a monthly rent schedule is a month-to-month tenancy. Thus, a tenant is only entitled to one notice to vacate which needs to expire before a UD action may be filed to evict them. [Palmer v. Zeis (1944) 65 CA2d Supp. 859]

• possession for an indefinite and unspecified period; and
• no provision for the payment of rent.

Situations giving rise to a tenancy-at-will include:

• when a tenant is granted the right to indefinitely occupy the property in exchange for services rendered [See Form 591 in Chapter 9];7
• when a tenant takes possession of the property under an unenforceable lease agreement (e.g., a written lease not signed by either party with terms orally agreed to) — unless rent is accepted to create a periodic tenancy;8 or
• when a tenant is given possession of the property while lease negotiations regarding the rent amount are still in progress and rent is not accepted.9

For a tenancy-at-will, a written notice to pay rent or quit is required to implement any change in the right to continue to occupy the premises, e.g., change it to a different kind of tenancy or terminate the tenancy. However, the parties can always agree to a shorter or longer notice period to accommodate the change.10 [See Case in point, “Periodic tenancy or tenancy-at-will?”]

Consider, an owner-occupant who agrees to sell their office building. The terms of the purchase agreement allow them to retain the free use and possession of the property until they can occupy an office building they are constructing. Thus, a tenancy-at-will is created.

The buyer agrees in the purchase agreement to give the seller a 90-day written notice to pay rent or vacate the property.

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7 Covina Manor Inc. v. Hatch (1955) 133 CA2d Supp. 790
8 Psihozios v. Humberg (1947) 80 CA2d 215
9 Miller v. Smith (1960) 179 CA2d 114
10 CC §95799, 1946
The buyer resells the property to a new owner. The new owner serves notice on the tenant-seller to pay rent or vacate in three days’ time. The new owner claims they are not subject to the prior owner’s unrecorded agreement to give a 90-day notice.

However, the new owner acquired the property subject to unrecorded rights held by the tenant in possession. Thus, the new owner is charged with constructive knowledge of the unrecorded agreement regarding 90-day notices to vacate and took title subject to the terms of the agreement.

Until the tenant-at-will receives the appropriate notice to vacate, they are not unlawfully detaining the property and the owner/landlord cannot proceed with a UD action to recover possession.11

However, a tenancy-at-will is automatically terminated if the tenant assigns or sublets their right to occupy the property to another tenant. The new tenant becomes a holdover tenant. Either form of possession is an unlawful detainer and grounds for eviction without notice.12

Also, a tenancy-at-will terminates on the death of either the landlord or tenant, unless an agreement to the contrary exists.13

When a fixed-term or periodic tenancy terminates by prior agreement or notice, the tenant who remains in possession unlawfully detains the property from the landlord. Likewise, a tenant-at-will who receives the appropriate notice to vacate and who remains in the property also unlawfully detains the property. These scenarios create a tenancy-at-sufferance, commonly referred to as a holdover tenancy. [See Case in point, “What steps does a landlord take to serve an unlawful detainer on a holdover tenant?”]

A holdover tenancy also arises on termination of a resident manager when the resident manager’s compensation includes the right to occupy a unit rent-free. When the landlord terminates the employment and the resident manager fails to vacate immediately, the resident manager unlawfully detains the premises as a holdover tenant.14 [See Form 591 in Chapter 9]

A holdover tenant retains possession of the premises without any contractual right to do so. Their tenancy has been terminated. Thus, the landlord is not required to provide a holdover tenant with any additional notice prior to commencing eviction proceedings.15

A holdover tenant no longer owes rent under the expired lease or terminated rental agreement since they no longer have the right of possession. However, the rental or lease agreement usually includes a holdover rent provision which calls for a penalty rate of daily rent owed for each day the tenant holds over.

11 First & C. Corporation v. Wencke (1967) 253 CA2d 719
12 McLeran v. Benton (1887) 73 C 329
13 Dugand v. Magnus (1930) 107 CA 243
15 CCP §1161
Chapter 2: The tenancies in real estate

If the rental or lease agreement does not contain a holdover rent provision, the tenant owes the landlord the reasonable rental value of the property. This is a daily rate owed for each day the tenant holds over. [See Case in point, “Reasonable rental value in a holdover tenancy”; see first tuesday Form 550]

Holdover rent is due after the tenant vacates or is evicted. At that time, the holdover period is known and the amount owed can be determined, and demanded. If it is not paid on demand, it can be collected by obtaining a money judgment.

But a caution to landlords: acceptance of holdover rent prior to a tenant vacating or being evicted has unintended consequences, as discussed in the next section.

A landlord, by using an improper notice, can create a different tenancy relationship from the one they initially conveyed to the tenant. A tenant’s possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice;
- expiration of a lease; or
- by conduct.

A classic example involves a change in the type of tenancy which arises when a holdover tenant becomes a month-to-month (periodic) tenant.

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**Facts:** An apartment landlord filed an unlawful detainer (UD) against a tenant who was unlawfully holding over. The landlord attempted to personally serve the UD on the tenant at the apartment address numerous times but the tenant was out of state. The landlord posted the notice on the property and mailed a copy to the tenant’s last known address, which was at the apartment. No other address for the tenant was available. The tenant did not receive or respond to the UD and the landlord took possession of the property.

**Claim:** The tenant sought to restore their tenancy claiming the landlord’s attempts to serve the UD were deficient since all the attempts were executed at the apartment address while the tenant was out of state and no other actions were taken to reach the tenant.

**Counter claim:** The landlord sought to prevent the tenant from restoring their tenancy, claiming sufficient actions were taken to notify the tenant of the UD since multiple attempts to notify the tenant were executed at the apartment address without response before posting the notice on the premises and no other address for the tenant was available.

**Holding:** A California Court of Appeals held the tenant may not regain possession since personal service was attempted and the notice was posted at the apartment address and no other address for the tenant was available for personal service or mailing. [The Board of Trustees of the Leland Stanford Junior University v. Ham (2013) 216 CA4th 330]

**Editor’s note –** A landlord is not required to expend an indeterminate amount of time and resources to track down an absent tenant in order to serve a UD. If the UD cannot be personally delivered, the landlord may leave a copy with a competent adult at the property or post it on the property, then send the documents by mail to the last known address of the tenant.

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**Case in point**

**What steps must does a landlord take to serve an unlawful detainer on a holdover tenant?**

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**Changing the type of tenancy**
A landlord who accepts any rent from a holdover tenant under an expired lease has elected by their conduct to treat the continued occupancy as a periodic tenancy.\(^{16}\)

Thus, the prerequisite to a UD eviction is the service of a proper notice to vacate on the holdover tenant who paid rent for the continued occupancy, rent the landlord accepted to create a periodic tenancy.\(^ {17}\)

If a landlord accepts rent from a holdover tenant after a fixed-term tenancy expires, the expired lease agreement is renewed on the same terms except for the period of occupancy, which is now periodic.\(^ {18}\)

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not renew the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — hence, one month if rent is paid monthly.\(^ {19}\)

A landlord who wants to terminate a periodic tenancy they created by accepting rent after expiration of a lease needs to serve the tenant with the proper notice to vacate and let it expire. On expiration of the notice, the tenant who remains in possession of the premises is unlawfully detaining the premises and the landlord may file a UD action to evict them.

A landlord and tenant can establish a shorter or lengthier notice period by agreement. However, the notice period cannot be less than seven days.

Other specialized rules exist for different types of properties and situations. For example, in a rent-controlled tenancy, terminating the right of possession is restricted by local ordinances.

\(^{16}\) Peter Kiewit Sons Co. v. Richmond Redevelopment Agency (1986) 178 CA3d 435

\(^{17}\) Colyear, supra

\(^{18}\) CC §1945

\(^{19}\) CC §1945
In a tenancy-at-will in a mobile home park, the tenant needs to be given a 60-day written notice.\(^{20}\)

Industrial and commercial tenants typically require three months minimum notice due to the time spent receiving and responding to a notice since it goes through multiple tiers of corporate management before a decision can be made.\(^{21}\)

In some instances, an extended 90-day notice is required to terminate residential tenancies in foreclosed properties. [See Chapter 23]

Another type of occupancy is to be differentiated from the leasehold interests discussed in this chapter. **Transient occupancy** is the occupancy of a vacation property, hotel, motel, inn, boarding house, lodging house, tourist home or similar sleeping accommodation for a period of 30 days or less. This type of occupant is classified as a **guest**, also called a **transient occupant**.

A transient occupant occupies property known as lodging, accommodation or unit, not space or premises. The property is not called a rental. The term “rental” implies a landlord/tenant relationship exists. Further, landlord/tenant law does not control transient occupancy.

The guest’s occupancy is labeled a **stay**, not possession. During a guest’s stay in the lodging, the owner or manager of the property is entitled to enter the unit at check-out time even though the guest may not yet have departed.

The contract entered into for the lodging is usually called a **reservation agreement**, but never a rental agreement or lease agreement. [See first tuesday Form 593]

Guests pay a daily rate, not a daily or weekly rent. They arrive at a pre-set date and time for check-in, not for commencement of possession. Likewise, guests depart at an hour on a date agreed to as the check-out time. Unlike a tenant, a guest does not vacate the premises; they check out.

When a guest fails to depart at the scheduled check-out hour on the date agreed, no holdover tenancy is created. Thus, an unlawful detainer does not exist as with a tenancy conveyed by a rental or lease agreement. A UD action or court involvement is not required to remove the guest.\(^{22}\)

However, for the owner or manager to avoid the landlord-tenant UD eviction process, the guest, when checking in, needs to sign a notice stating:

- the unit is needed at check-out time for another guest who has been promised the unit; and
- if the guest has not departed at check-out time, the owner or manager may enter, take possession of the guest’s property, re-key the doors and clean up the unit for the next guest.\(^{23}\) [See first tuesday Form 593]

\(^{20}\) CC §798.55(b)  
\(^{21}\) CC §1946  
\(^{22}\) CC §1940(b)  
\(^{23}\) CC §1865
To remove a guest who fails to timely depart the unit and remains in the unit after a demand has been made to leave, the manager can intervene to remove the guest, a solution called **self-help**. If the manager’s intervention might cause a breach of the peace, the manager may call the police. The police or the sheriff will assist, without the need for a court order, to remove the guest and prevent a danger to persons or property during the re-keying, removal of possessions and clean up for the arrival of the next guest.\(^{24}\)

Transient occupancies include all occupancies that are taxed as such by local ordinance or could be taxed as such by the city or by the county.

Taxwise, the guest occupancy is considered a personal privilege, not a tenancy. Time share units when occupied by their owners are not transient occupancies and are not subject to those ordinances and taxes.\(^{25}\)

Transient units do not include residential hotels since the occupants of residential hotels treat the dwelling they occupy as their *primary residence*. Also, the occupancy of most individuals in residential hotels is for a period of more than 30 days.

Also, the operator of a residential hotel may not require a resident to change units or to check out and re-register in order to avoid creating a month-to-month tenancy which would place the occupancy under landlord/tenant law. A residential hotel operator violating this rule is liable for a $500 civil penalty and attorney fees.\(^{26}\)

A broker or any other person who manages “vacation rental” stays for owners of single family homes, units in a common interest development (condominium project), units in an apartment complex or any other residence subject to a local transient occupancy tax, is to maintain accounting records. Further, the property manager needs to send a monthly accounting statement to each landlord they represent and make the records available for inspection and reproduction by the owner. They need to also comply with the transient occupancy tax regarding collection, payment and record keeping.\(^{27}\)

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\(^{24}\) Calif. Penal Code §6020(s)
\(^{25}\) Calif. Revenue and Taxation Code §7280
\(^{26}\) CC §1940.1
\(^{27}\) CC §1864
A fixed-term tenancy is the result of an agreement between the landlord and the tenant for a fixed rental period. A periodic tenancy automatically continues for equal, successive periods of time, such as a week or a month.

In a tenancy-at-will, possession is delivered to the tenant with the landlord’s knowledge and consent for an indefinite and unspecified period, usually without requiring rent. A holdover tenancy is the result of a tenant retaining possession of a rented premises without any contractual right to do so.

A tenant’s possessory interest in real estate can shift from one type of tenancy to another based on conduct of the landlord.

The type of notice required to terminate occupancy depends on the period of the tenancy or occupancy, the period of the occupancy, the property type and location.

holdover rent ......................................................... pg. 14
holdover tenant ..................................................... pg. 14
lease agreement ....................................................... pg. 11
periodic tenancy ...................................................... pg. 12
rental agreement ...................................................... pg. 12
reservation agreement ............................................. pg. 17
transient occupancy ............................................... pg. 17
trespasser .............................................................. pg. 10
unlawful detainer ..................................................... pg. 10
Unbeknownst to a residential landlord, a tenant changes the locks on the door to the rented unit. Several months later, the tenant is arrested by law enforcement officers as they step out of their apartment. The tenant is hastily escorted away, leaving lights on and their pet inside, but locking the door.

The landlord becomes aware of the tenant’s dilemma. Fearful the gas stove was also left on, the landlord attempts, but is unable to enter with their key.

The landlord calls the police to witness their entry and inspection of the apartment to make sure it is in a safe and secure condition. The landlord then enters the apartment through a window. The police are let in to observe the landlord’s conduct.

The police proceed to make a visual inspection of the apartment.
Unfortunately for the tenant, the police find illegal possessions in plain view casually lying around the kitchen and dining area of the apartment.

Did the landlord have the right to enter the apartment? Did the landlord have the right to allow the police to enter the apartment?

Yes to both! The landlord had the right to enter since they reasonably believed the safety of their other tenants and the building may be in jeopardy.

Also, the police were present at the request of the landlord to act as eyewitnesses so the tenant may not claim the landlord removed any of the tenant’s possessions. ¹

In contrast, consider the landlord who permits the police to enter and search a tenant’s garage without a warrant.

The police have reason to believe the tenant is manufacturing drugs, an illegal use of the premises and of concern to the landlord.

May a landlord collaborate with the police at their request and allow them to enter a tenant’s garage?

No! The landlord has no right of possession when the tenant’s right of possession has not expired or been terminated. This is true even if the tenant has vacated and only one day remains under a 30-day notice to vacate.

If the tenant’s right of possession has not expired, the landlord has no possessory right. Thus, they are prohibited from entering the property or letting the police enter the property, even if the landlord suspects the tenant of using the premises to commit a crime. The police need to first obtain a search warrant to legally authorize them to come onto the premises occupied by the tenant when the landlord has no right to entry. ²

However, a landlord does have the right to enter and also to allow police to enter a unit which has been abandoned or vacated by the tenant if the tenancy has been terminated under state law rules of abandonment or surrender. ³ [See Chapter 23]

Further, “lock-box” entry by the police in collaboration with a multiple-listing service (MLS) member to check out a crime is prohibited without a warrant. The entry violates the purpose of a seller’s broker’s agency and lock-box authority. The broker may enter only to show the premises to prospective tenants who accompany them (or other authorized agents). ⁴

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¹ People v. Plane (1969) 274 CA2d 1
² United States v. Warner (9th Cir. 1988) 843 F2d 401
³ United States v. Sledge (9th Cir. 1981) 650 F2d 1075
⁴ People v. Jaques (1985) 169 CA3d 918
Chapter 3: Landlord’s right to enter

A landlord’s right to enter a residential or nonresidential unit during the period of the tenant’s right to occupy the premises is severely limited. The possessory rights to occupy the property have been conveyed to the tenant and are no longer held by the landlord, until a reversion of possession occurs on termination of the tenancy.

A residential landlord may enter the tenant’s actual dwelling space during the term of the rental or lease agreement only in limited circumstances:

- in an emergency;
- to make repairs, alterations, improvements, or supply services that are either necessary or previously approved by the tenant;
- to complete a pre-expiration inspection for deficiencies which would result in a deduction from the security deposit [See Chapter 14];
- to show the unit to prospective buyers, prospective tenants, lenders, repairmen or contractors;
- when the tenant has vacated the premises and their right to occupy has been terminated by surrender or abandonment; or
- under a court order allowing entry.5

A property manager’s entry into a tenant’s unit out of concern for the safety of the property or other tenants constitutes an emergency. The property manager may properly enter the unit without the tenant’s knowledge and permission for the limited purpose of dealing with the emergency.6

Consider a nonresidential lease agreement that prohibits any tenant violations of government laws and regulations.

The landlord asks the tenant for permission to conduct tests on the property and investigate whether the leased property contains any contamination from hazardous waste. The tenant refuses to give the landlord permission to conduct the investigation, claiming the landlord does not have a right to determine whether contamination exists until the lease expires.

Here, the landlord, on advance notice to the tenant, has the right to access the property to determine if contamination has or is occurring on the property. Hazardous waste contamination is a violation of law and a breach of the lease provision prohibiting unlawful activities which adversely affect the value of the property.7

Before a residential landlord may proceed with any maintenance or services which require entry into a tenant’s unit, the tenant needs to be given a written notice of the landlord’s intent to enter. Maintenance includes all routine or non-emergency repairs, decorations, alterations, improvements, replacements or services, whether or not agreed to by the tenant.8 [See Form 567 accompanying this chapter]

5 Calif. Civil Code §1954
6 Plane, supra
8 CC §1954
The written notice gives the tenant a reasonable time period to prepare for the entry. A 24-hour notice is considered reasonable, unless extenuating circumstances known to the landlord or their property managers, such as the tenant’s vacation or business trip, indicate the tenant needs more time to receive the notice and prepare for the entry.

Service of a 24-hour notice of entry in advance of the entry is accomplished by any one of the following methods:

- handing a written notice to the tenant personally;
- handing the notice to an occupant of the unit who appears of suitable age and discretion to relay the notice to the tenant; or
- posting the notice on, near or under the usual entry door so it will be discovered by the tenant.

Alternatively, the notice may be mailed, but at least six days is to pass after mailing before the intended entry can be scheduled to occur.9

A notice is sufficient to request entry during normal business hours, emergencies excepted. However, to request entry after business hours, the tenant’s consent needs to be obtained “at the time of entry.”

The notice procedures may not be used to harass a tenant in a retaliatory or abusive manner.10

A tenant in a community apartment project or a homeowner in a common interest development (CID) is to receive at least 15 days but no more than 30 days written notice when the management or association needs the occupants to vacate the project in order to treat termites. Condominium projects and planned unit developments are examples of CIDs.11
A residential landlord may enter a tenant’s unit after further notice to the tenant when the tenant requests a joint pre-expiration inspection of the premises. The tenant’s request is usually in response to the landlord’s initial notice mandated to inform the tenant of the tenant’s right to a joint inspection. [See Chapter 14]
The purpose of the pre-expiration inspection prior to termination of the tenancy is to advise the tenant of any deficiencies in the condition of the premises. The tenant can then correct or eliminate any deficiencies before vacating and avoid deductions from the security deposit.

Before the residential landlord may enter to conduct the agreed-to pre-expiration inspection, the tenant is given a 48-hour written notice stating the date and time for the inspection.\footnote{CC §1950.5(f)(1)}
Service of the 48-hour notice of entry is accomplished in the same manner as for the 24-hour notice of advance entry to complete repairs. However, the tenant may waive the 48-hour notice if both the tenant and the landlord sign a written waiver.\(^\text{13}\)

A residential or nonresidential property occupied by a tenant is called a rental. Real estate brokers who list rentals for sale need to inform the seller of the seller’s right to coordinate prospective buyer inspections of the property. These inspections can be completed using one of two notice procedures.\(^\text{14}\)

\(^{13}\) CC §1950.5(f)(1)

\(^{14}\) CC §1954
The first notice procedure works exactly the same as the 24-hour written notice of entry for repairs. This notice may also be mailed, as discussed in the prior section.

The second, or alternative notice procedure to the 24-hour written notice is a 120-day "For Sale" notice. The “For Sale” notice may be given to the tenant personally or by regular mail at any time after the seller enters into a listing to sell the property. [See Form 116 accompanying this chapter]

The “For Sale” notice commences a 120-day “for sale” period. During this period, the seller or the seller’s agent may enter the unit during normal business hours with a prospective buyer to conduct an inspection of the unit. [See Case in point, “Are weekends normal business hours?”]

Prior to the time for entry during the “for sale” period, the tenant receipt of the notice is to be given no less than 24 hours advance notice by phone or in person of the actual entry date and time. The actual entry is conditioned on the listing agent leaving a written note in the unit regarding the entry and completion of the inspection. [See Form 116-1 accompanying this chapter]

Here, the giving of the 24-hour notice by phone, during the 120-day period following service of the written “For Sale” notice, is exclusively the right of the seller and their listing agent. The buyer’s agent needs to arrange for the listing agent to give the 24-hour advance telephonic notice. The buyer’s agent does not have, and may not be given the authority to notify the tenant (unless they are also the listing agent).

Thus, on taking a listing to sell property occupied by tenants, the listing agent needs to inform the seller of the two available notice-of-entry procedures.

Once resolved as to which notice procedure the seller is willing to authorize in the listing agreement, the information is shared with buyer’s agent.

This information regarding a buyer’s access to the listed property is reported in MLS listings under “showing instructions.” For example, “Call the listing office (LO) or listing agent (LA) to arrange for 24-hour telephonic (or alternative written) notice of entry.”

Once informed of the procedure for entry and inspection, some sellers may restrict inspections of the property to qualified buyers who have entered into a purchase agreement. Thus, sellers might not allow prospective buyers to preview the premises until they have entered into a purchase agreement and been financially qualified as capable buyers.

A landlord or their manager may enter a unit when:

- the tenant’s right of possession has been terminated; and
- the tenant has vacated the unit.

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15 CC §1954(d)(2)
Caution: the tenant vacating the property does not automatically trigger a termination of the tenant’s right of possession. The tenant’s leasehold right of possession is terminated by:

- the expiration of a lease (or rental agreement, by a proper notice to vacate) [See Chapter 23];
- a properly-established surrender [See Chapter 19];
- an abandonment, with a notice of abandonment [See Chapter 18]; or
- a forfeiture, with a three-day notice containing a declaration of forfeiture. [See Chapter 18]

A landlord has the right to recover possession of the premises due to a forfeiture declared in a three-day notice to quit, or expiration of the rental or lease agreement. However, a landlord may only enforce their right to recover possession from a holdover tenant by the legal eviction process. Self-help is absolutely unacceptable.

For example, in an unlawful detainer (UD) action, a landlord obtains a UD judgment against a tenant when the tenant fails to promptly answer the UD lawsuit. Before the eviction is carried out under the court order, the court “sets aside” the judgment. The court-ordered eviction order is now invalid.

Even though the landlord knows the eviction order is invalid, the landlord privately calls on two uniformed county marshals to assist in the eviction. Without knowing the eviction order is invalid, the two marshals demand the tenant vacate the unit.

The tenant leaves the unit immediately and the landlord takes possession. Later, the tenant seeks a money judgment against the landlord claiming the conduct of the landlord was a forcible entry and detainer of the premises.

The landlord claims their conduct cannot be considered a forcible entry and detainer since the method used to evict the tenant did not lie entirely outside
the law. The landlord obtained a court order (although they knew it was invalid) and did not personally evict the tenant (they used law enforcement officers instead).

However, the landlord is liable for forcible entry and detainer. They caused the tenant to be evicted by using a judgment which they knew to be invalid. The landlord's use of uniformed law officials to carry out the entry and removal of the tenant does not excuse the landlord's use of a known invalid eviction order. The landlord is still using self-help methods to regain possession of the premises since the eviction was not court-ordered.16

Now consider a nonresidential landlord who obtains only a money judgment against their tenant for unpaid rent. The landlord does not obtain an order authorizing the tenant’s eviction. However, a court clerk erroneously issues a writ of possession authorizing the landlord’s recovery of the property, via the sheriff. Consequently, the tenant is evicted by the sheriff.

The tenant now seeks to recover possession. The money judgment did not award the landlord possession of the premises or include an eviction order. The court later recalls the writ as having been erroneously issued, but refuses to order the landlord to surrender possession of the property to the tenant.

The tenant seeks to recover their money losses for the eviction. The tenant claims the landlord is liable for forcible entry and detainer since the landlord had the tenant removed under an invalid writ of possession.

The landlord claims they are not liable for forcible entry or detainer since they relied on court authorization to evict the tenant and recover possession of the premises.

Here, the landlord is not liable for the tenant’s money losses. Imposing liability on landlords who, in good faith, rely on erroneous court orders would undermine the public policy favoring orderly judicial process (instead of self help).17

Rental and lease agreements occasionally contain an unenforceable provision stating the landlord has the right to enter and retake possession of the premises upon a tenant’s breach of the rental or lease agreement. However, the tenant’s default does not alone constitute a forfeiture or convey the leasehold and its possessory rights to the landlord.

To terminate the tenant’s right of possession after a breach, the landlord serves the tenant with a three-day notice to cure the breach, pay rent or quit. The notice includes a declaration of lease forfeiture if the landlord is to terminate the tenant’s right of possession on expiration of the notice.

If the landlord attempts self-help and takes possession without the tenant’s consent, the landlord is committing a forcible entry. The landlord thus becomes liable for the tenant’s money losses.18

A tenant’s right of possession arises out of their ownership of a leasehold estate in the property.19

The tenant retains the right of possession unless and until it is terminated by proper notice or the expiration of a lease agreement. The only other enforceable transfer of the right of possession is through voluntary conveyance.

To recover the property after the tenant’s breach, the landlord either serves the tenant with the required notice or the tenant voluntarily conveys the right of possession back to the landlord. Again, the landlord’s self-help is not an enforceable transfer of the tenant’s right of possession.

In exchange for voluntarily giving up possession, the tenant usually seeks a cancellation of the lease agreement (or some other consideration).

Consider an owner who goes on an extended overseas vacation. The owner rents out their home to a tenant for the duration of their trip. The rental agreement provides for the tenant to vacate on the owner’s return.

The owner returns from their trip, but the tenant refuses to relinquish possession of the house. While the tenant is at work, the owner enters the house, removes the tenant’s belongings and retakes possession of the property based on a provision in the rental agreement stating they have the right of re-entry.

Can the owner use self-help to dispossess the tenant?

No! So long as the tenant’s right of occupancy remains unterminated by notice or agreement, the tenant has the right to exclude others, including the fee owner, from possession. This right is created by all rental or lease agreements since they grant an exclusive right of possession.

An owner, even though entitled to possession by agreement, cannot re-enter the premises without first obtaining a court order.

**Forcible entry** by a landlord or property manager is an unlawful activity consisting of:

- peaceable entry by open doors, windows or other parts of the premises without permission, prior notice or justification;
- entry by any kind of violence or threat of terror; or
- peaceable entry after which threats, force or menacing conduct is used to dispossess the tenant.20

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18 *Lamey v. Masciotra* (1969) 273 CA2d 709
19 CC §1953(a)(1)
20 Calif. Code of Civil Procedure §1159
Actions by a landlord, property manager or resident manager construed as an illegal forcible entry include:

- entry resulting from any physical acts of force or violence;
- entry through a window and removal of the tenant’s belongings in the occupant’s absence;\(^{21}\)
- entry under the false pretense of making an inspection and then taking possession from the tenant;\(^{22}\)
- entry by unlocking the door of the unit in the tenant’s absence;\(^{23}\)
- entry accomplished by a locksmith who opens the door during the tenant’s absence;\(^{24}\) and
- entry by breaking locks.\(^{25}\)

**Forcible entry and self-help**

For instance, consider an occupant whose rent is paid by their employer under a lease agreement entered into solely by the employer and the landlord. It names the employer as the tenant on the lease.

Later, the occupant’s employment is terminated and the employer informs the occupant and the landlord that the employer will no longer pay the rent. Upon a request from the employer, the landlord enters without the occupant’s permission, changes the locks and forces the occupant to vacate the premises. No notice is served on the occupant and no UD action is filed.

Is the landlord guilty of forcible entry even though the occupant was no longer employed by the tenant, and was not named as the tenant on the lease?

Yes! While the occupant’s employment was terminated and the employer informed the landlord they would no longer pay rent, the occupant was in possession under a lease agreement which had not been terminated. The landlord’s attempt to oust the occupant by entering against the occupant’s will and changing the locks on the employer’s breach of the lease is an example of both forcible entry and self-help.\(^{26}\)

**Tenant’s possessions as security**

Some lease agreements contain an unenforceable clause purporting to give the landlord the right to take or hold the tenant’s personal property as security upon the tenant’s default on the lease.

For example, a tenant enters into a lease agreement and occupies the unit. The agreement authorizes the landlord to re-enter the unit on the tenant’s default in the payment of rent and take the tenant’s personal possessions as security until the rent is paid.

\(^{21}\) *Bank of California v. Taaffe* (1888) 76 C 626

\(^{22}\) *White v. Pfeffer* (1913) 165 C 740

\(^{23}\) *Winchester v. Becker* (1906) 4 CA 382

\(^{24}\) *Karp v. Margolis* (1968) 159 CA2d 69

\(^{25}\) *Pickens v. Johnson* (1951) 107 CA2d 778

\(^{26}\) *Spinks v. Equity Residential Briarwood Apartments* (2009) 171 CA4th 1004; CCP §5159, 1160
Chapter 3: Landlord’s right to enter

The tenant fails to pay rent and the payment becomes delinquent. To enforce the security provision in the lease, the landlord uses their key to enter the unit in the tenant’s absence and remove the tenant’s possessions. The landlord then refuses to allow the tenant to re-enter the unit until the rent is paid.

Here, the landlord may not enter and interfere with the tenant’s continued access to the premises based on the tenant’s default on the lease agreement. The landlord needs to first obtain a court order. It does not matter how peaceably the landlord accomplished the entry, since without a court order they are guilty of forcible entry and detainer.\(^{27}\)

Forcible entry into premises leased to a tenant occurs whenever anyone enters the tenant’s premises without the tenant’s present consent.

Consider a hotel operator who as a tenant encumbers their leasehold interest in a hotel with a trust deed to provide security for a loan. The trust deed states the lender may appoint a trustee to take possession of the real estate and operate and manage the hotel when the hotel operator defaults on repayment of the loan.

The operator defaults on the loan. The lender appoints a trustee in compliance with the trust deed provisions. The trustee goes to the hotel to remove the hotel operator from the premises as agreed by the provision in the trust deed.

The trustee, although not entering the premises by force, breaks and replaces locks on the storage cabinets. The trustee raids cash registers and threatens to harm the hotel operator if they refuse to relinquish possession of the hotel.

Is the trustee guilty of forcible entry onto the property even though the trustee was appointed under a trust deed provision agreed to by the operator and used non-violent means to enter the premises?

Yes! The trustee holds the same status as the secured lender. They have no more right of possession than the lender. This is in spite of prior agreements granting authority to the trustee to take possession on default.

The trustee’s right of possession, like that of a landlord, may only be lawfully obtained by a UD action against the interest in the property encumbered by the trust deed. After obtaining ownership of the tenant’s rights by holding a trustee’s sale of the tenant’s rights under the leasehold interest securing the loan, the trustee or the lender (or other highest bidder) is then required to serve the appropriate notice to vacate. Only upon the expiration of the notice to vacate would they be able to file a UD action and obtain possession.\(^{28}\)

Even a tenant can be guilty of a forcible entry.

Consider a prospective tenant who enters into a rental agreement without inspecting the premises.

\(^{27}\) *Jordan v. Talbot* (1961) 55 Cal.2d 597

\(^{28}\) *Calidino Hotel Co. of San Bernardino v. Bank of America Nat. Trust & Savings Ass’n* (1939) 31 Cal.2d 295;
When they inspect just before taking possession, they discover the physical condition of the premises is unacceptable and refuse to take possession. As a result, the landlord does not give the tenant a key or any other means of access to the premises.

The landlord, realizing they will not be able to rent the property until the premises is restored, renovates the property. Upon the landlord’s completion of the renovations, the would-be tenant climbs through an open window in the landlord’s absence and takes possession of the premises. They claim the rental agreement the landlord and tenant entered into grants them the right of possession of the unit.

Here, the tenant did not have authority from the landlord to occupy the premises. The rental agreement was canceled by the tenant’s conduct when they refused to accept delivery of possession and was not given access to the premises. The tenant’s occupancy was gained only by their unauthorized and peaceful entry, legally called forcible entry.29

Landlord as co-tenant with roommates

Consider the owner of a single family residence who rents rooms to individuals, called roommates. Soon, the owner spends less and less time residing on the property. However, the owner continues to maintain their mailing address at the residence.

After a week-long absence, the owner returns and discovers the locks on all the doors have been changed. They break a window and enter the property. The roommates claim the owner is guilty of forcible entry since they broke into the property.

Did the owner’s roommates have the exclusive right of possession barring the owner from entering the property without prior notice?

No! The owner was not attempting to regain lost possession. Rather, they were a co-occupant in actual possession of the premises with others at the time of their entry.

The owner and their roommates had joint possession. No one roommate had been given exclusive possession against any other roommate. As a joint possessor with the right to occupy the premises concurrently with others, the owner is not liable for forcible entry.30

Losses due to wrongful dispossession

A tenant wrongfully removed from their rented premises by a landlord or property manager is entitled to a return of their possession of the premises for the duration of the lease. This is called restitution.31

In addition to recovery of possession, a tenant may recover all money losses caused by the landlord’s wrongful entry. The tenant may only collect losses

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29 McNeil v. Higgins (1948) 86 CA2d 723
30 Bittman v. Courington (1948) 86 CA2d 213
31 CCP §51174(a)
incurred while they were dispossessed of the property, but retained a legal right of possession. Thus, they are not entitled to any losses incurred after the expiration or termination of their tenancy under a rental or lease agreement.\textsuperscript{32}

For example, a nonresidential tenant is served a 30-day notice to vacate to terminate their month-to-month tenancy.

Then, the tenant defaults on the rental agreement. Prior to the expiration of the notice to vacate and due to the default, the landlord bars the tenant from entering the premises. The tenant is unable to continue operating their business from the property. The tenant does not regain possession of the premises before their right of possession is terminated by expiration of the notice to vacate.

Is the tenant entitled to recover business income losses due to the landlord’s unlawful detainer of the property?

Yes! A tenant whose possession is interfered with can recover their money losses due to:

- lost profits, limited to the net operating income (NOI) they failed to earn during the balance of the unexpired term;\textsuperscript{33}
- rental value of the lost use of the premises;\textsuperscript{34}
- emotional distress caused by the landlord or property manager’s conduct towards the tenant;\textsuperscript{35} and
- loss of \textit{business goodwill} (earning power of the business).\textsuperscript{36}

If the tenant has built up goodwill with the customers of their business, the remaining days of their period of tenancy are used to advise customers of their expired lease and new location. The landlord who forcibly enters the leased premises during the remaining period of the tenancy is liable for the tenant’s money losses due to loss of \textit{business goodwill}.\textsuperscript{37}

A landlord who willfully or maliciously takes possession from the tenant is liable to pay up to three times the tenant’s actual money losses to the tenant. These treble damages are inflicted as a judicial punishment to deter bad acts, and are known as \textit{punitive damages}.

For example, a landlord seeking to collect a debt owed by their tenant bars the tenant’s employees from the leased premises by changing the locks and refusing the tenant access to records and personal property.

Here, the landlord is acting with malice and the tenant may recover treble the amount of their actual money losses.\textsuperscript{38}

\begin{itemize}
\item \textsuperscript{32} CCP §1174(b); \textit{Orly v. Russell} (1921) 53 CA 660
\item \textsuperscript{33} \textit{Orly}, supra
\item \textsuperscript{34} \textit{Stillwell Hotel Co.}, supra
\item \textsuperscript{35} \textit{Newby v. Alto Riviera Apartments} (1976) 60 CA3d 288
\item \textsuperscript{36} \textit{Schuler v. Bordelon} (1947) 78 CA2d 581
\item \textsuperscript{37} \textit{Schuler}, supra
\item \textsuperscript{38} \textit{Civic Western Corporation v. Zila Industries, Inc.} (1977) 66 CA3d 1
\end{itemize}
A landlord or property manager using actual force or violence to enter a leased unit is guilty of a misdemeanor crime.\footnote{39 Calif. Penal Code §418}

**Chapter 3**

**Summary**

A landlord may enter a rented premises:

- in an emergency;
- to make repairs or improvements;
- to complete a pre-expiration inspection;
- to show the unit to prospective buyers, tenants, lenders, repairmen or contractors;
- when the tenant has vacated the premises and their right to occupy has been terminated by surrender or abandonment; or
- under a court order allowing entry.

In most circumstances, prior notice of the entry is to be given to the tenant.

A landlord (or any other person) who enters the property without permission is guilty of unlawful forcible entry.

**Key Terms**

- business goodwill ........................................................ pg. 35
- forcible entry ............................................................... pg. 31
- notice of entry .............................................................. pg. 24
- punitive damages ......................................................... pg. 35
- restitution ................................................................. pg. 34
- self-help .................................................................... pg. 29
Chapter 4: Tenant leasehold improvements

Tenant leasehold improvements

After reading this chapter, you will be able to:

- identify the different types of tenant improvements;
- understand the landlord’s rights regarding tenant improvements on the termination of a lease; and
- determine the landlord or tenant’s obligation to complete or pay for the construction of tenant improvements.

A retail business owner enters into a nonresidential lease agreement to occupy commercial space as a tenant. The leased premises do not contain tenant improvements since the building is nothing more than a shell.

The tenant agrees to make all the tenant improvements needed to occupy the premises and operate a retail business (i.e., interior walls, flooring, ceilings, air conditioning, electrical outlets and lighting, plumbing, sprinklers, telephone and electronic wiring, etc.).

The lease agreement provides for the property to be delivered to the landlord on expiration of the lease “in the condition the tenant received it,” less normal wear and tear. No other lease provision addresses whether tenant improvements will remain with the property or the property is to be restored to its original condition when the lease expires.
On expiration of the lease, the tenant strips the premises of all of the tenant improvements and vacates. The building is returned to the landlord in the condition it was found by the tenant: an empty shell, less wear and tear. In order to relet the space, the landlord replaces nearly all the tenant improvements that were removed.

Is the tenant liable for the landlord’s costs to replace the tenant improvements removed by the tenant on vacating?

Yes! Improvements made by a tenant that are permanently affixed to real estate become part of the real estate to which they are attached. Improvements remain with the property on expiration of the tenancy, unless the lease agreement explicitly requires the tenant improvements to be removed and the property to be restored to its original condition.¹

However, the landlord’s right to improvements added to the property or paid for by the tenant depends upon whether:

- the tenant improvements are permanent (built-in) or temporary (free-standing); and
- the lease agreement requires the tenant to remove improvements and restore the premises.

All improvements attached to the building become part of the real estate, except for trade fixtures (discussed later in this chapter).²

Examples of improvements that become part of the real estate include:

- built-ins (i.e., central air conditioning and heating, cabinets and stairwells);
- fixtures (i.e., electrical and plumbing);
- walls, doors and dropped ceilings; and
- attached flooring (i.e., carpeting, tile or linoleum).

Nonresidential lease agreements typically contain a further-improvements provision allowing the landlord to either:

- retain tenant improvements and alterations made by the tenant; or
- require restoration of the property to its original condition on expiration of the lease. [See first tuesday Form 552 through 552-5]

Further-improvement provisions usually include clauses stating:

- who will make the improvements (landlord or tenant);
- who will pay for the improvements (landlord or tenant);
- the landlord’s consent is required before the tenant makes improvements;

¹ Calif. Civil Code §1013
² CC §660
Chapter 4: Tenant leasehold improvements

- any *mechanic's liens* due to improvements contracted by the tenant will be removed;
- the condition of the premises on expiration of the lease; and
- whether the improvements are to remain or be removed on expiration of the lease. [See *first tuesday* Form 552 §11]

A landlord under a lease agreement who agrees to make improvements to the rented premises needs to complete the improvements in a timely manner. If the landlord fails to make timely improvements, the tenant may cancel the lease agreement. [See *first tuesday* Form 552 §3.3]

For example, a landlord agrees to make all the improvements necessary to convert a ranch into a dairy farm for a tenant who operates a dairy.

The landlord is obligated to construct a barn and several sheds that are essential to the operation of the tenant’s dairy business.

The tenant moves into the property before the improvements begin. Several months pass and the landlord does not begin construction on the promised improvements. The tenant vacates the property since it is impossible to conduct a dairy business without the dairy barn.

Here, the landlord’s failure to make the promised improvements is a breach of the lease agreement.

Since the landlord has breached an essential provision of the lease, the tenant may vacate the property and cancel the lease agreement without obligation to pay further rent.3

Conversely, lease agreement provisions can obligate a tenant to construct or install improvements on the rented property, whether improved or unimproved. The time period for commencement and completion needs to be provided for in the lease agreement. If not agreed to, a reasonable period of time is allowed.4

However, a tenant may fail to make or complete mandated improvements prior to expiration of the lease. If the improvements are to remain with the property, the tenant is liable to the landlord for the cost the landlord incurs to complete the agreed-to improvements.

For example, a tenant agrees to construct additional buildings on a leased property in lieu of paying rent for one year. When the lease expires, the improvements will remain with the property since the lease agreement does not call for restoration of the premises.

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3 *Souza v. Joseph* (1913) 22 CA 179
4 CC §1657
The tenant fails to construct the buildings during the term of the lease. The tenant claims the obligation to build was not a mandatory improvement, but permissive. According to the tenant, the obligation to build only existed if it was necessary for the operation of the tenant’s business.

Here, the improvements were agreed to in exchange for rent. Accordingly, the tenant was required to make the improvements since the landlord bargained for them in the lease agreement. Thus, the landlord is entitled to recover an amount equal to the cost of the improvements the tenant failed to construct.

Additionally, if the tenant agrees to but does not complete the construction of improvements that are to remain with the property on expiration of the lease, the landlord may complete those improvements. The tenant is then financially responsible for the landlord’s expenditures to construct the improvements.

Even after the expiration of the lease, a landlord is entitled to recover lost rent and expenses resulting from the tenant’s failure to construct the improvements as promised.

Consider a landlord who enters into a lease agreement calling for the landlord to construct a building on the leased property. After the foundation is laid, the landlord and tenant orally modify the construction provisions. The tenant agrees to finish construction of the building in exchange for the landlord forgoing their construction profit.

The tenant then breaches the oral modification of the written lease agreement by failing to complete the construction. The breach places the landlord in financial jeopardy as they now need to complete the building. The landlord terminates the tenant’s right to occupancy, evicts the tenant and completes the construction promised by the tenant.

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5 Simen v. Sam Aftergut Co. (1915) 26 CA 361
6 Sprague v. Fauver (1945) 71 CA2d 333
Here, the tenant is not only responsible for the landlord’s costs of construction, they are also liable for future rents under the lease agreement. In addition, they are liable for any expenses the landlord incurs to relet the property since the landlord’s conduct did not cancel the lease agreement. [See Case in point, “The controlling lease agreement”]

Lease provisions often allow a tenant to make improvements to the leased premises. However, further-improvement provisions typically call for the landlord to approve the planned improvements before construction is commenced.

For example, a tenant wishes to add additional space to the premises they leased for use in the operation of their business. The tenant begins construction without obtaining the landlord’s prior approval as required by the lease agreement. Further, the addition is located outside the leased premises, an encroachment on other land owned by the landlord.

In the past, the landlord had approved tenant improvements. This time, however, the landlord refuses to give consent and complains about the construction and the encroachment.

The landlord continues to accept rent while the landlord and tenant negotiate the approval of the additional improvements and the modification of the lease agreement to include use of the area subject to the encroachment.

After a few years of negotiations without resolution, the landlord declares a forfeiture of the lease. The forfeiture is based on both the breach of the provision requiring the landlord’s prior consent to construction and the encroachment of the unapproved improvements.

The tenant then claims the landlord waived their right to declare a forfeiture of the lease since the landlord continued to accept the rent from the tenant after the breach of the tenant-improvement provision and encroachment.

However, as long as negotiations to resolve the breach continue, a landlord may accept rent from the tenant without waiving their right to consent to additional improvements.

Likewise, consider a tenant with an option to buy the property they rent. The tenant makes improvements with the expectation of ultimately becoming the owner of the property by exercising the option to buy.

Here, the tenant is not entitled to reimbursement for the cost of improvements if the fail to exercise their purchase option. Holding an option to buy is not fee ownership and the improvement becomes part of the real estate. Thus, the improvements will not belong to the tenant unless the tenant exercises their option to buy and becomes the owner of the property.

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8 Thriftmart, Inc. v. Me & Tex (1981) 123 CA3d 751
9 Whipple v. Haberle (1963) 223 CA2d 477
Some lease agreement provisions allow a tenant to make necessary improvements without the landlord’s further consent. These improvements are not specifically mandated, or required to be completed in exchange for a reduction in rent. Recall that this nonmandatory type of improvement is called a **permissive improvement**.

For example, a landlord and tenant sign a long-term lease agreement. Its further-improvements provision authorizes the tenant to demolish an existing building located on the property and construct a new one in its place without first obtaining the landlord’s consent. The rent is based solely on the current value of the premises.

The further-improvements provision does not state a specific time period for demolition or construction.

The tenant makes no effort to tear down the old building or erect a new one. Ultimately, the landlord claims the tenant has breached the lease agreement for failing to demolish the existing building and construct a new one.

Here, the tenant has not breached the lease agreement. The agreement contained no promise by the tenant to build and the rental amount was not based on the construction. The tenant was authorized to build without need for the landlord’s approval, but was not obligated to do so. Thus, the improvements on the tenant’s part were permissive, not mandatory.10

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**Permissive improvements by the tenant**

A nonmandatory improvement authorized to be completed by the tenant without further landlord consent.

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**Mandatory improvements**

A further-improvements provision that requires a tenant to construct improvements at a rent rate reflecting the value of the land, has different consequences.

If a date is not specified for completion of the improvements, the tenant needs to complete construction within a reasonable period of time since construction of improvements is mandated to occur.

For example, a landlord leases unimproved land to a developer who is obligated to build improvements, contingent on obtaining a construction loan. A time period is not set for commencement or completion of the construction. However, a cancellation provision gives the tenant/developer the right to cancel the lease agreement within one year if financing is not found to fund the construction. No provision authorizes the landlord to terminate the lease if the required construction is not completed.

Due to the onset of a recession, the tenant is unable to arrange financing within the one-year period. However, they do not exercise their right to cancel the lease agreement and avoid payment of future rents. Instead, the tenant continues their good faith effort to locate and qualify for construction financing. Ultimately, financing is not located and construction is not commenced.

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10 *Kusmark v. Montgomery Ward and Co.* (1967) 249 CA3d 585
A few years later, as the economy is showing signs of recovery, the landlord terminates the lease. The landlord claims the lease agreement has been breached since the promised construction was not completed.

The tenant claims the landlord cannot terminate the lease as long as the tenant continues their good faith effort to locate financing and remains solvent to qualify for the financing.

Here, the tenant has breached the lease agreement. They failed to construct the intended improvements within a reasonable period of time. The original purpose of the lease was to have buildings erected without specifying a completion date. Following the expiration of the right to cancel, the landlord gave the tenant a reasonable amount of time in which to commence construction before terminating the lease.

When the original purpose for the lease was the construction of a building by the tenant, a landlord cannot be forced to forgo the improvements bargained for.11

All tenant improvements are to remain with the leased property on termination of a lease unless the lease agreement permits or mandates their removal by the tenant as a restoration of the premises.

Most lease agreements merely provide for the property to be returned in good condition, minus ordinary wear and tear for the years of the tenant's occupancy. Thus, the tenant is not required to restore the property to its actual condition when they took possession since tenant improvements are part of the real estate.

A provision calling for the tenant’s ordinary care of the premises does not also require the tenant to remove their improvements or renovate the premises to eliminate deterioration, obsolescence or normal wear and tear caused by the tenant’s permitted use of the property.12

Now consider a landlord and tenant who enter into a lease of nonresidential property. The lease agreement contains a provision requiring the tenant, at the landlord's demand, to restore the premises to the original condition received by the tenant, less normal wear and tear.

The tenant makes all the tenant improvements necessary to operate their business, such as installation of a concrete vault, the removal of partitions and a stairway, and the closing of two entrances into the premises.

On expiration of the lease, the tenant vacates the premises. The landlord exercises their right to require removal of tenant improvements by making a demand on the tenant to restore the premises. The tenant rejects the landlord’s demand.

The landlord incurs costs to restore the premises for reletting to a new tenant.

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11 City of Stockton v. Stockton Plaza Corporation (1968) 261 CA2d 639
The landlord claims the tenant is liable for the landlord’s costs incurred to restore the premises since the tenant’s improvements radically altered the premises and made it unrentable to others.

The tenant claims they are not liable for the landlord’s costs to restore the premises to its original condition since the alterations became part of the real estate and were beneficial to the property.

Is the tenant liable for the landlord’s costs to restore the premises to a rentable condition?

Yes! Here, the landlord exercised their option to call for removal of the improvements under the lease agreement provisions. The lease provisions called for restoration of the premises to its original condition on a demand from the landlord.

On the tenant’s failure to restore the premises, the landlord was forced to incur restoration costs to relet the premises. The tenant is liable for the landlord’s expenditures to restore and relet the premises to a new tenant.13

If a lease does not require the tenant to restore the property to the condition it was in when received, the tenant may only remove their personal improvements, called *trade fixtures*.

Two types of fixtures exist distinguishing improvements installed in a building:

- **real estate fixtures**; and
- **trade fixtures**.

A *real estate fixture* is personal property that is attached to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property.14

For example, if a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall, the bookshelves become part of the improvements located on the real estate.

When the lease expires, real estate fixtures become the landlord’s property. The landlord takes possession of the real estate fixtures as part of the real estate forfeited or surrendered to the landlord, unless the lease agreement provides for restoration or permits removal by the tenant. The conveyance of real estate fixtures from tenant to landlord on expiration of the lease is called *reversion*.15

Conversely, *trade fixtures* do not revert to the landlord on expiration of the lease. A trade fixture is an improvement that is attached to the real estate by the tenant and is unique to the operation of the tenant’s business, not the use of the building.

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13 Masonic Temple Ass’n. of Sacramento v. Stockholders Auxiliary Corporation (1933) 130 CA 234
14 CC §566; 1013
15 City of Beverly Hills v. Albright (1960) 184 CA2d 360
Consider a tenant who leases property to operate a beauty salon. The tenant moves in work-related furnishings (i.e., mirrors, salon chairs, wash stations and dryers), necessary to run the business. The items are attached to the floor, walls, plumbing and electrical leads.

On expiration of the lease, the tenant removes the fixtures that were used to render the services offered by the business. The landlord claims the fixtures are improvements to the property and cannot be removed since they became part of the real estate when installed.

However, furnishings unique to the operation of a business are considered trade fixtures even though the furnishings are attached and built into the structure. Trade fixtures are removable by the tenant.

A tenant may, at the end of or anytime during the lease term, remove any fixture used for trade purposes if the removal can be done without damaging the premises.\(^\text{16}\)

Fixtures that have become an integral part of the building’s structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures which cannot be removed include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings.\(^\text{17}\)

What compensation may be due to a tenant who has improved the property and is wrongfully evicted prior to expiration of a lease?

A tenant who is wrongfully evicted is entitled to the rental value of their improvements for the remainder of their unexpired lease term. Without reimbursement, the landlord receives a windfall profit for their use of the tenant’s improvements until they revert to the landlord on expiration of the original lease.

The tenant is not, however, entitled to reimbursement for the market value or cost of the improvements.

Thus, a wrongfully evicted tenant is limited to collecting the reasonable value for the landlord’s use of the improvements during the remainder of the term on the original lease.\(^\text{18}\)

Lease agreements often contain a default provision prohibiting the tenant from removing the trade fixtures when the agreement is breached. The tenant (and their unsecured creditors) no longer has a right to the trade fixtures under a default provision.

Consider a tenant who signs a commercial lease agreement to use the premises to operate a frozen packaging plant. The lease agreement states all fixtures, trade or leasehold, belong to the landlord if the lease is terminated due to a breach by the tenant.

\(^{16}\) Beebe v. Richards (1953) 115 CA2d 589
\(^{17}\) CC §1019
\(^{18}\) Assi v. Rodrigues (1973) 32 CA3d 817
The tenant later encumbers the existing trade fixtures by borrowing money against them. The tenant then defaults on their lease payments. While in default on the lease, the tenant surrenders the property to the landlord, including all trade fixtures.

Does the lender on the loan secured by the trade fixtures have a right to repossess them?

No! The tenant lost their ownership right to remove the trade fixtures under the terms of the lease agreement that was entered into before they encumbered the trade fixtures. Any right to the fixtures held by the secured lender is similarly lost since the lender is junior in time and thus subordinate to the landlord’s interest in the fixtures under the lease agreement.

However, if the trade fixtures installed by the tenant are owned by a third party, or if a third party had a lien on them at the time of their installation, the landlord has no more right to them than the tenant.19

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any mechanic’s lien by a contractor for nonpayment initially attaches to the tenant’s leasehold interest in the property.20

However, the mechanic’s lien for unpaid labor and materials may also attach to the fee simple interest held by the landlord if the landlord or the landlord’s property manager:

- acquires knowledge the construction is taking place; and
- fails to post and record a Notice of Nonresponsibility. [See Form 597 accompanying this chapter]

A Notice of Nonresponsibility is a written notice which needs to be:

- posted in a conspicuous place on the premises within ten days after the landlord or their property manager first has knowledge of the construction; and
- recorded with the county recorder’s office within the same ten-day period.21

However, the landlord who becomes aware of the construction and fails to post and record the Notice of Nonresponsibility is not personally liable to the contractor. Rather, the contractor can only lien the landlord’s interest in the real estate and foreclose on their mechanic’s lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant.22

20 CC §8442(a)
21 CC §8444
22 Peterson v. Freiermuth (1911) 17 CA 609
Further, if the lease requires the tenant to make mandatory improvements, a mechanic’s lien attaches to the landlord’s interest even when the landlord has posted and recorded a Notice of Nonresponsibility.

For example, a lease states the tenant is to make certain improvements as a condition of renting the property. Since the improvements are mandatory improvements rather than permissive improvements, the tenant is deemed to be the landlord’s agent. The tenant is contracting for the construction of the mandated improvements on behalf of the landlord.
Thus, the mechanic’s lien incurred by the tenant will attach to both the tenant’s and the landlord’s interest in the property, despite any posted and recorded Notice of Nonresponsibility.23

Had the lease merely authorized the tenant to make nonmandatory (permissive) improvements, the tenant will not be acting as an agent for the landlord. In that case, the landlord’s interest in the property is not subjected to a mechanic’s lien if the Notice of Nonresponsibility is timely posted and recorded on discovery of the tenant improvements.24

23 Los Banos Gravel Company v. Freeman (1976) 58 CA3d 785
Additionally, a mechanic's lien cannot be recorded against the landlord if the improvements are removed by the contractor recording the lien.

For example, a tenant contracts to have air conditioning installed in the building the tenant rents. The contractor sells the equipment to the tenant under a conditional sales contract. The contractor retains title to the equipment as security until the sales contract debt is paid.

The landlord's consent to the improvements is not obtained by the tenant, but the landlord has knowledge the work has commenced. The landlord does not post a Notice of Nonresponsibility.

Later, after the air conditioning units are installed, the tenant vacates the property.

The contractor is not paid and files a mechanic's lien against the landlord's fee interest in the property. Further, the contractor repossesses the air conditioning units and resells them at a loss. The contractor then seeks to recover their losses under the mechanic's lien.

However, by electing to repossess the units, the contractor waived their right to pursue the mechanic's lien to foreclosure.

Whether the air conditioning units are considered a removable fixture due to the financing, or a property improvement permitting the recording of a mechanic's lien, is no longer an issue after their removal. The contractor removed the units and chose to treat the units as personal property. Thus, the contractor lost their lien rights for nonpayment.25

Consider the tenant who leases a property containing tanks for holding gasoline. The tenant negotiates a reduced rental payment in exchange for installing fuel pumps free of any liens.

The tenant purchases the pumps on credit and the pumps are installed. The supplier of the pumps does not receive a Uniform Commercial Code (UCC-1) financing statement from the tenant. Thus, the supplier does not file a UCC-1 with the Secretary of State, a requisite to perfecting the supplier's lien on the pumps. [See Figure 1, Form 436-1]

Later, the pump supplier claims title to the pumps due to the unpaid installation debt and seeks to repossess them.

However, the landlord owns the pumps as fixtures which became part of the real estate. The landlord gave consideration in the form of reduced rent to acquire the pumps. More importantly, the pump supplier failed to perfect its lien on installation of the pumps.26

25 Cornell v. Sennes (1971) 18 CA3d 126
26 Southland Corp. v. Emerald Oil Company (9th Cir. 1986) 789 F2d 1441
Tenant improvements are improvements made to a rented property to meet the needs of the occupying tenant. The landlord's right to tenant improvements depends upon whether the tenant improvements are a real estate fixture or a trade fixture, and whether the further-improvements provision in the lease agreement requires the tenant to remove improvements and restore the premises.

A tenant's or landlord's liability for failing to construct or pay for tenant improvements depends on whether the tenant improvements are mandatory or permissive.

**Chapter 4**

**Summary**

Tenant improvements are improvements made to a rented property to meet the needs of the occupying tenant. The landlord's right to tenant improvements depends upon whether the tenant improvements are a real estate fixture or a trade fixture, and whether the further-improvements provision in the lease agreement requires the tenant to remove improvements and restore the premises.

A tenant's or landlord's liability for failing to construct or pay for tenant improvements depends on whether the tenant improvements are mandatory or permissive.

**Chapter 4**

**Key Terms**

- further-improvements provision......................................................pg. 38
- mandatory improvement.................................................................pg. 40
- mechanic's lien ................................................................................pg. 46
- notice of nonresponsibility ..............................................................pg. 46
- permissive improvement.................................................................pg. 42
- real estate fixture ............................................................................pg. 44
- reversion ..........................................................................................pg. 44
- tenant improvements .................................................................pg. 37
- trade fixture ......................................................................................pg. 44
Options and the right of first refusal to buy

Tenants often need to invest substantial dollar amounts in tenant improvements to tailor newly leased premises to their needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements in:

- a lump sum;
- upfront expenditures; or
- payments amortized over the initial term of the lease, calculated by the landlord and included in the monthly rent.

Installation of racks, cabinets, shelving, trade fixtures, lighting and other interior tenant improvements will also be paid for by the tenant. Further, the business builds up a significant degree of goodwill with customers due to the fixed location over a number of years. Thus, the location and improvements become part of the income generating value of the tenant’s business.
All these expenditures will be lost if the landlord refuses to extend the lease, or if their demands for increased rent under an option to extend compel the tenant to relocate. A retail tenant with even a small degree of insight into their future operations at the location will attempt to negotiate some sort of option to purchase the property.

The tenant who has paid rent that includes the amortization of TIs paid by the landlord needs to negotiate an option to extend at a lesser rental rate than during the initial term. Here the tenant has already paid for the tenant improvements on the property, a monthly payment that is not paid again under an option to extend or renew the lease.

An option to purchase included in a lease agreement is distinct from:

- the purchase rights held by a tenant under a right of first refusal; or
- the ownership rights held by a buyer under a lease-option sales arrangement. [See first tuesday Form 163]

A landlord grants a tenant an option to purchase by entering into either:

- an irrevocable right to buy the property within a specific time period, called an option to buy; or
- a pre-emptive right to buy the property if the landlord later decides to sell the property, called a right of first refusal.

The option to buy is typically evidenced by a separate agreement attached to the lease agreement. An option to buy includes terms of purchase, none of which are related to the lease of the property. The option to buy is to always be referenced in the lease agreement and attached as an addendum.

An option to buy contains all terms needed to form an enforceable purchase agreement for the acquisition of the real estate. The tenant holding an option to buy has the discretionary right to buy or not to buy on the sales terms stated in the option. To exercise the option, the tenant does so within an agreed-to time period. No variations are allowed. Thus, the option is a purchase agreement offer irrevocably agreed to by the seller to sell, but the buyer has not agreed to buy. [See Form 161 accompanying this chapter]

To actually buy the property under an option, the tenant exercises their right to buy through acceptance of the irrevocable offer to sell granted by the option. Conversely, the right of first refusal is a short agreement with its provisions either included in the body of the lease agreement or by an addendum. Unlike the option to buy, the right of first refusal provisions rarely contain any terms of a sale.

Under an option to buy agreement, the tenant is not obligated to buy the leased property. The tenant is merely given the right to buy if they so choose. This is a type of call option. [See first tuesday Form 161]
For the option to be enforceable, the purchase price of the property and terms of payment on exercise of the option are included in the option agreement. If the dollar amount is not set as a specific amount in the option agreement, the purchase price may be stated as the fair market value of the property at the time the option is exercised.

The right to buy is exercised by the tenant within a specified time period, called the **option period**. The option period typically runs until the lease expires, including extensions/renewals, or is terminated. [See Form 161 §4]

If the option is not exercised precisely as agreed during the **option period**, the option period expires of its own accord. On expiration, the option no longer exists and the tenant is without an enforceable right to acquire the property.¹

When options to renew or extend leasing periods are negotiated as part of the leasing arrangements, the expiration of the option to buy is tied by agreement to either:

- the expiration of the initial lease term; or
- the expiration of any renewal, extension or continuation of the tenant’s lawful possession.

For example, a tenant rents space under a ten-year lease with an **option to extend** the term of the lease. The tenant also holds an option to buy the leased property. The option references the lease term as the period for exercise of the option to buy.

If the lease is later extended, the option period is automatically extended with the extension of the lease. Here, the option to buy allows the tenant to exercise the option during the lease term which includes any extensions.²

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¹ Bekins Moving & Storage Co. v. Prudential Insurance Company of America (1985) 176 CA3d 245
² In re Marriage of Joaquin (1987) 193 CA3d 1539
Now consider a lease agreement which contains an **option to renew** the lease agreement instead of an option to extend. This is a distinction with a complication. The renewal option requires the preparation and signing of a new lease agreement on identical terms to the original lease agreement. The initial lease agreement, by way of a referenced attachment, provided the tenant with an option to buy which can be exercised prior to the expiration of the lease.
On renewal of the lease agreement, the tenant needs to ensure the option to buy is not left to expire at the end of the initial lease term. The new lease agreement is a different contract and needs to also reference the option to buy (as part of the identical terms of the original lease) since a new lease is not an extension of any of the terms of the original lease.\(^3\)

\(^3\) In re Marriage of Joaquin, supra
The right of first refusal to buy

A tenant’s right to buy under a right of first refusal agreement can be triggered by any indication of the landlord in a decision to sell the property, including:

- listing or advertising the property for sale;
- offering the property for sale to a buyer;
- accepting an offer or making a counteroffer involving a sale to a buyer; and
- granting a purchase option.

As shown, the landlord does not need to first agree to sell the leased property by entering into a purchase agreement with another person to trigger the right of first refusal.

For example, a buyer contacts the landlord of leased commercial property to make an offer to purchase the property. The buyer is informed the major tenant holds the right to buy the property under a right of first refusal provision in the lease.

The buyer attempts to circumvent the right of first refusal by negotiating an option to buy the property, exercisable only after the tenant’s right of first refusal expires. The landlord grants the buyer an option to buy the property. The granting of the option — an irrevocable offer to sell — now binds the landlord unconditionally to sell the property if the option is exercised.

Here, the landlord’s granting of the option to sell the property is a clear indication of their intention to sell, triggering the right of first refusal. The tenant is now allowed to purchase the property on the same terms as contained in the buyer’s option.⁴

Editor’s note — The right of first refusal is not triggered by conveyance of the property to the landlord’s heirs on the landlord’s death. The heirs take title subject to the right of first refusal. However, the right of first refusal is triggered by a sale of the property ordered by the probate court or entered into by the heirs. To exercise the right of first refusal, the tenant matches the highest offer submitted in open bidding and approved by the court, or the listing or sale of the property by an executor.⁵

Once notice of the landlord’s decision to sell is delivered to the tenant, the right of first refusal is transformed into an option to buy. Control of the transaction then passes to the tenant holding the right of first refusal. The tenant’s position under the right of first refusal is converted to that of an optionee on terms set by the landlord, unless the right of first refusal provisions set some or all of the terms.

The landlord may not now retract their decision to sell the property without breaching the right of first refusal provision.

Matching the back-up offer

The landlord subject to a right of first refusal held by a tenant is obligated to notify the tenant of the terms of any sales listing, option to buy, offer to

⁴ Rollins v. Stokes (1981) 123 CA3d 701
⁵ Estate of Patterson (1980) 108 CA3d 197
purchase, counteroffer or acceptance of an offer to purchase which triggers the tenant’s right to buy under the right of first refusal provision. [See Form 579 accompanying this chapter]

The tenant who decides to purchase the property agrees to match the sales terms within the time period set in the right of first refusal provision. Failure to do so is a failure to exercise their right of first refusal, resulting in a loss of their right to buy.
Consider a tenant who holds a right of first refusal on the industrial property they lease. A buyer makes an offer to purchase the property. The terms for the payment of the price in the buyer’s offer include cash and an assumption of the existing first trust deed on the property.

The property is also encumbered with a nonrecourse second trust deed to be paid off and reconveyed on closing under the terms of the buyer’s offer. The landlord accepts the offer and notifies the tenant, giving the tenant the opportunity to match the buyer’s offer under the right of first refusal provision in the lease agreement.

The tenant exercises their right of first refusal by agreeing to purchase the property at the same price. However, the tenant alters the terms for payment of that price as they will assume both the existing first trust deed and nonrecourse second, paying the remainder of the price in cash.

The landlord rejects the tenant’s conditions and refuses to sell to the tenant.

Here, the landlord is to comply with the tenant’s terms for payment of the price since they are the financial equivalent of the proposed sale. The tenant need merely provide the same net financial result to the landlord as the offer being matched — a cash-out of the landlord’s equity in the property.

The tenant’s performance under the right of first refusal does not need to be identical in all aspects to the buyer’s offer.

Thus, the landlord is to perform and deliver title to the tenant. Here the landlord’s net proceeds, economic benefits and liabilities resulting from the terms for performance set by the tenant are the same as those the landlord experiences under the purchase offer which triggered the right of first refusal.6

Consider a buyer who offers to purchase property leased to a tenant who holds a right of first refusal. The terms in the buyer’s purchase agreement call for a cash down payment and a note executed by the buyer for the balance of the landlord’s equity. The note is to be secured by a trust deed on other property with adequate value as security.

The landlord accepts the offer and notifies the tenant, who agrees to match the buyer’s offer. However, the value of the property offered by the tenant as security is inadequate, causing the landlord to refuse to accept it.

Here, the tenant’s offer is not financially equivalent to the buyer’s offer since the value of the security offered by the tenant is inadequate, even if the note is identical. In the tenant’s offer, the risk of loss on default has been increased.

The landlord is not obligated to accept the tenant’s deficient exercise of their preemptive right to buy. Here, the tenant’s deficient offer constitutes a waiver of the tenant’s right to buy. The landlord may now sell the property to the buyer — but only on the terms initially agreed to with the buyer or the right of first refusal is reinstated.7

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Chapter 5: Options and the right of first refusal to buy

A right of first refusal provision is automatically reinstated when:

- the landlord agrees to sell the property on terms different from those terms offered to the tenant; or
- the property remains unsold after the running of an agreed-to period of time following the tenant’s waiver of the right to buy. [See Form 579 §4]

Consider a landlord who, under a right of first refusal, notifies their tenant of the purchase terms on which they have listed the property for sale. The
A landlord gives a tenant the right to buy rented property by granting either:

- an option to buy, which is an irrevocable right to buy the property within a specific time period; or
- a right of first refusal, which is a pre-emptive right to buy the property if the landlord later decides to sell the property.

The right to buy under an option to buy will be exercised by the tenant within the option period. The option period typically runs until the lease term expires or is terminated.

A tenant’s right to buy under a right of first refusal agreement is triggered by any indication of the landlord’s decision to sell the property, including:

- listing or advertising the property for sale;
- offering the property for sale to a buyer;
- accepting an offer or making a counteroffer involving a sale to a buyer; and
- granting a purchase option.

To exercise the right of first refusal to buy, the tenant needs to agree to match the sales terms set by the landlord within the time period set in the right of first refusal provision.

When a buyer purchases the property on terms other than those offered to the tenant, the buyer takes title subject to the tenant’s preemptive right to buy. This right is reinstated due to the sale on different terms. Thus, the buyer is to resell to the tenant on the same price and terms the buyer paid. The buyer had either actual or constructive notice of the tenant’s unrecorded right to acquire the property due to the tenant’s possession of the property.
Chapter 6: Property management licensing

Property management licensing

After reading this chapter, you will be able to:

• identify licensing requirements for property managers and their employees;
• differentiate between activities which require a license and activities which do not require a license; and
• distinguish state-mandated licensing from third-party designations.

certified CID manager power of attorney
contingency fee

An individual owns and operates income-producing real estate. As the owner-operator, they locate and qualify tenants, prepare and sign occupancy agreements, deliver possession, contract for property maintenance, collect rent, pay expenses and mortgages, serve any notices and file any unlawful detainer (UD) actions to evict tenants.

Does the owner-operator need a California Bureau of Real Estate (CalBRE) broker license to perform these activities?

No! The owner of income-producing real estate does not need a real estate broker license to operate as a principal. The owner-operator is not acting on behalf of someone else as an agent when managing their own property.¹

Editor’s note — Here, the generic term “agent” refers to anyone who acts on behalf of another. Confusingly, the term “agent” is also used in the real

¹ Calif. Business and Professions Code §10131(b)
estate industry to refer to a CalBRE-licensed sales agent, or salesperson. To simplify, the rest of this chapter will only use the term “agent” to refer to a CalBRE-licensed individual.

On the other hand, if the owner-operator decides to hire an individual to take over the general management of the apartment complex, the individual employed to act as property manager needs to under most circumstances be licensed by the CalBRE as a California real estate broker.

Editor’s note — A broker has the authority to act as a property manager by virtue of their CalBRE license alone. There is no special “property management” license or endorsement required under California law. Optional designations are discussed later in this chapter.

An individual or corporation is to hold a broker license if they perform or offer to perform any of the following services on behalf of another in exchange for a fee:

- listing real estate for rent or lease;
- marketing the property to locate prospective tenants;
- listing prospective tenants for the rental or lease of real estate;
- locating property to rent or lease;
- selling, buying or exchanging existing leasehold interests in real estate;
- managing income-producing properties; or
- collecting rents from tenants of real estate.2

An individual employed by a broker to perform any of the above services needs to also be licensed by the CalBRE, either as a broker or sales agent, unless exempt.

2 Bus & P C §10131(b)

Sidebar

DCA Guide for Landlords and Tenants

The California Department of Consumer Affairs (DCA) publishes a booklet titled: California Tenants: A Guide to Residential Tenants’ and Landlords’ Rights and Responsibilities. The purpose of the booklet is to equip tenants with the knowledge to act as savvy consumers during lease negotiations and to protect themselves from ignorant or unethical landlords during tenancy.

It also includes valuable information for landlords and property managers.

California Tenants solely address residential tenancies and includes practical information on topics including:

- security deposits;
- habitability of rented or leased premises;
- disclosure requirements; and
- fair housing laws.

This publication is updated regularly by the DCA and is available from their website and on first tuesday’s Forms-on-CD 4.3 in the “FARM Letters and Other Publications” section.
Administrative and non-discretionary duties performed by an employee of a broker who manages transient housing or apartment complexes are exempt from real estate licensing requirements while the employee is under the broker’s supervision and control.³

Thus, an employee hired to assist the broker in the rental and leasing of residential complexes, other than single family units, may be either:

- **licensed**; or
- **unlicensed**.

Unlicensed employees may perform tenant-related negotiations in apartment and vacation rentals, such as:

- showing rental units and facilities to prospective tenants;
- providing prospective tenants with information about rent rates and rental and lease agreement provisions;
- providing prospective tenants with rental application forms and answering questions regarding their completion;
- accepting tenant screening fees;
- accepting signed lease and rental agreements from tenants; and
- accepting rents and security deposits.⁴

**Licensed employees** may perform any activities unlicensed employees perform. However, licensed employees are additionally able to perform activities relating to contacts with the landlord, as opposed to the tenant, about the leasing, care of the property and accounting.

Activities which only licensed employees may perform include:

- landlord-related solicitations;
- entering into property management or leasing agent agreements with the landlord;
- listings and rental or lease negotiations;
- care and maintenance of the property;
- marketing of the listed space; and
- accounting.

Also exempt from licensing is an individual who has been given authority to act as an “attorney in fact” under a **power of attorney** to temporarily manage a landlord’s property.⁵ [See *first tuesday* Form 447]

However, a **power of attorney** may not be used as authority to continuously manage real estate and does not substitute for a broker license.

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³ Bus & P C §10131.01(a)
⁴ Bus & P C §10131.01(b)(1)
⁵ Bus & P C §10133(a)(2)
Consider a landlord who can no longer handle the responsibilities of managing their property due to illness. The landlord grants a power of attorney to a friend to manage the property. The landlord pays their friend for performing property management tasks, including locating tenants, negotiating leases and collecting rent.

After the landlord’s recovery from their illness, they continue to employ their friend to perform these management tasks.

Does the landlord’s friend need a real estate broker license to perform property management tasks on a regular, on-going basis in exchange for a fee, even though the landlord has given them a power of attorney?

Yes! The power-of-attorney exemption may only be used in situations where the landlord is compelled by necessity, such as a vacation or illness, to authorize another person to complete a specific or isolated transaction.

A person receiving a fee for the continuous performance of property management tasks requiring a broker license may not rely on the power-of-attorney exemption to avoid licensing requirements.6

Apartment building management has special licensing rules distinguishing resident managers from nonresident property managers.

A resident manager is employed by either the landlord or the broker who manages the apartment building or complex. The resident manager lives on the premises as a requirement of their employment.

A resident manager and their employees do not need a real estate license to manage the apartment complex.7

However, a resident manager of one apartment complex is barred from being the property manager of a separate apartment complex unless they are licensed. In managing two complexes, the resident manager becomes a nonresident property manager of one complex. Thus, they need to be licensed.8

Apartment complexes with 16 or more units are required to have a resident manager.9

A person is not required to have a real estate broker license when they are acting:

- as an attorney performing management as part of their legal services10;
- or
- under court appointment, such as a receiver or bankruptcy trustee.11

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7 Bus & P C §10131.01(a)(1)
8 Bus & P C §10131(b)
9 25 Calif. Code of Regulations §42
10 Bus & P C §10133(a)(3)
11 Bus & P C §10133(a)(4)
These exceptions are usually short-term and refer to specific properties.

A person whose business is advertised or held out as including property management for others needs to comply with the licensing laws. Individuals managing property without a license and without qualifying for an exemption will not be able to enforce collection of the fee they were to receive.\(^\text{12}\)

If a landlord is a corporation, limited liability company (LLC) or partnership, any officer of the entity may manage the entity’s property without a broker license. However, the unlicensed officer may not receive any contingency fees or extra compensation based on achievement, production or occupancy factors during their management of the property. They are to be salaried or on wages. The same rules apply to resident managers.\(^\text{13}\)

For example, a corporation owns a shopping mall managed by an officer of the corporation. The officer’s duties include maintaining the premises, locating tenants and collecting rents.

As the manager, the corporate officer is paid an annual salary as a base pay. Whenever a vacancy occurs in the mall, the manager locates a new tenant and negotiates the lease for the corporation. For each new tenant, the manager receives an *incentive fee* over and above their corporate salary. This acts as a bonus for their successful efforts.

Here, the manager needs to be licensed as a broker even though they are an officer and employee of the corporation that owns the property. The manager’s earnings include extra compensation based on their performance of real estate management activities requiring a license.

The manager’s receipt of an incentive bonus payment for leasing space establishes that the manager is acting as a broker, not merely as a salaried officer of the corporate owner. If the corporation holds a CalBRE corporate license, then the employed individual only needs to be a licensed salesperson. The exclusion of employees from licensing in residential rental complexes for tenant-related contacts does not apply to nonresidential leasing.

Similarly, where an LLC owns the property, the manager of the LLC need not be licensed to manage the property — provided fees are not paid based on the quantity of leases negotiated or the LLC’s rental income.\(^\text{14}\)

If the LLC manager receives a percentage of gross rents as compensation, the compensation is considered a contingent fee unless all the members of the LLC receive the same percentage.

A property manager paid on a *contingency fee* basis, or any other employee or officer whose pay is structured as a *contingency fee*, of an office building, 

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\(^\text{12}\) Bus & P C §10137
\(^\text{13}\) Bus & P C §10133(a)(1)
\(^\text{14}\) Bus & P C §10133(a)(1)
shopping center, industrial park, apartment building or other income property will need a broker license if their duties include recruiting tenants, negotiating leases or collecting rents. However, employees of a broker dealing exclusively with prospective tenants for units in apartment complexes or vacation rentals are not required to possess a license.\textsuperscript{15}

Bonus, award, commission, incentive or \textit{contingency fee} programs in excess of a base salary require the person receiving them to be licensed by the CalBRE, whether they are resident managers, assistant resident managers or maintenance personnel. Examples of these programs include:

- a flat dollar fee for each new tenant;
- a monthly flat dollar fee for each new tenant;
- a percentage fee based on increases in rents; and
- a percentage of monthly gross rents if rents collected for the month exceed a percentage of scheduled income.

A broker license does not automatically confer on the broker the designation of \textit{certified common interest development (CID) manager}. Also, it is not mandatory for a broker to be “certified” to manage a common interest development, but some employers may request it. \textsuperscript{[See Chapter 7]}

The benchmark professional certification is the Certified Community Association Manager. This certification is issued by the California Association of Community Managers. This designation is not an activity involving the CalBRE. However, the minimum educational criteria for becoming a certified CID manager are set by California law.\textsuperscript{16}

When earning a designation as a certified CID manager, the manager is tested for competence in CID management in the following areas:

- all subjects covered by the Davis-Stirling Common Interest Development Act\textsuperscript{17};
- personnel issues related to independent contractor or employment status, laws on harassment, the Unruh Civil Rights Act, The California Fair Employment and Housing Act and the Americans with Disabilities Act;
- risk management, including insurance coverage and residential hazards; and
- federal, state and local laws governing the affairs of CIDs.

Any program claiming to certify CID managers will also instruct and test managers for competency in general management and business skills, such as:

- trust fund handling, budget preparation, and bankruptcy law;
- contract negotiation;

\textsuperscript{15} \textit{Bus & P C} §10131(b)
\textsuperscript{16} \textit{Bus & P C} §§11502, 11503
\textsuperscript{17} \textit{CC} §4000
• supervision of employees and staff;
• management and administration of maintenance, and CC&R’s
• owner/resident relations and conflict resolution and avoidance mechanisms;
• architectural standards;
• how to implement association CC&Rs; and
• ethics, professional conduct and standards of practice for CID managers.18

It is considered an unfair business practice for a broker to label or advertise themselves as “certified” to manage CIDs if the broker has not completed such a course.19

It is a widely held misconception that property managers are required to hold a Certified Property Manager (CPM) membership with the Institute of Real Estate Management (IREM) to perform property management activities.

The CPM designation is a non-required unofficial designation bestowed by a private non-regulatory organization. Brokers and agents may earn them by completing private coursework and submitting proof of a certain number of years of property management experience.

Other non-required third-party property management designations include:
• the certified apartment manager (CAM) designation;
• the accredited resident manager (ARM) designation;
• the registered in apartment management (RAM) designation; and
• the certified apartment supervisor (CAPS) designation.

Like the certified CID manager designation, the CPM designation is not required to be employed. Unlike the CID manager designation, the criteria for obtaining these designations are entirely determined by private organizations.

The designations are often costly, and do not guarantee employment in property management. Some employers may favor such designations, while others may not recognize them at all.

18 Bus & P C §11502
19 Bus & P C §11504
Chapter 6
Summary

An individual or corporation need to hold a broker license if they perform or offer to or perform any property management services on behalf of another for a fee. An individual employed by the broker to perform activities related to contacts with the landlord also needs to hold a broker or sales agent license.

However, several licensing exemptions exist. A broker who manages apartment complexes and vacation properties may hire unlicensed staff to perform administrative and non-discretionary duties. Resident managers, attorneys, bankruptcy trustees, and (to a limited extent) those who hold power of attorney are not required to be licensed.

Third-party property management designations exist, but are not required for employment.

certified CID manager .......................................................... pg. 66
contingency fee ................................................................. pg. 65
power of attorney ............................................................... pg. 63

Chapter 6
Key Terms
After reading this chapter, you will be able to:

- understand the function of a property management agreement to grant authority to operate a rental property and specify the performance expectations of the landlord and the manager;
- handle rental payments received from tenants and operating expenses, and provide periodic trust fund accounting to the landlord;
- distinguish the different ways a property manager may structure their fee schedule for their management of a property;
- perform duties specific to a common interest development (CID) upon entering into a property management agreement with the homeowners’ association (HOA) controlling the CID; and
- identify and apply the landlord’s and property manager’s rights and responsibilities under the management agreement.

**Key Terms**

- common interest development
- managing agent
- property management agreement

A property manager’s authority to take possession and control of income-producing real estate and manage its leases, rents, expenses, mortgage payments and accounting in expectation of a fee is established in a **property management agreement**. The property management agreement sets out the specific rights, responsibilities and expectations of the property manager and the landlord, including authorized activities, performance standards and expense limitations. [See Figure 1, Form 590]
Landlord responsibilities include providing the property manager with the information and items necessary to manage the property and its tenants, such as:

- lease/rental agreements;
- service and maintenance contracts;
- utilities information;
- keys and security devices;
- security deposits; and
- information on hazard and worker’s compensation insurance for the property and employees.

The property management agreement authorizes the property manager to:

- locate tenants;
- enter into rental and lease agreements, including leases for a term of over one year;
- deliver possession of units or space;
- collect rents;
- incur operating expenses; and
- disburse funds to pay expenses, loan payments and management fees.¹

Brokers who manage property need to enter into highly detailed property management agreements, not generalized “short-form” property management agreements.

Short-form agreements neither specifically identify nor clarify the performance and expectations of either the property manager or the landlord. Instead, short-form agreements imply industry customs will be followed — whatever those unregulated customs might be or become.

These implied standards, while familiar to the broker, are often misunderstood or unknown to the landlord. Disputes usually result when landlords have high expectations and then receive less than they believe they bargained for when they employed the property manager.

Management obligations detailed in a long-form agreement provide greater protection for a broker from claims they have breached their duties to the landlord. Surprises are eliminated and client expectations are more realistic.

Some landlords want their property maintained at a below-standard level. A broker taking on the management of a property from such a landlord needs to document the maintenance they recommend. This can be accomplished by adding an addendum to the property management agreement or by

¹ Calif. Civil Code 51624(a)(3)
sending estoppel letters to the landlord stating the maintenance situation, the broker’s recommendations, and a request for authority to act on the recommendations.

For example, a property manager needs to document a landlord’s refusal to maintain landscaping, as overgrown or top-heavy landscaping can result in structural damage, injury to the tenants or a failure of proper security.
Also, a property manager needs to note any advice given, explained and then rejected by the landlord regarding the installation or maintenance of security systems, lighting or other improvements or maintenance needed to eliminate dangerous conditions.

**Handling rents and expenses**

Property management agreements authorize the property manager to act on behalf of the landlord to handle all income received and incur expenses in the operation of the property.

The property manager’s responsibilities regarding the property’s income and expenses include:

- collecting rents and other amounts due, such as common area maintenance charges (CAMs) and assessments for property insurance and real estate taxes;
- collecting, accounting for and refunding security deposits;
- paying expenses and loans payments from rents received from tenants; and
- complying with any local rent control ordinances.

**Trust accounts for the landlord’s funds**

A property management agreement spells out which maintenance expenses, insurance premiums, utilities, loan payments, management fees and property taxes are to be disbursed by the property manager, and which are to be separately paid by the landlord.

The receipt and accounting for cash reserves, security deposits, rent and other sums received from tenants, coin-operated machines and concessions will be handled as trust funds owned by the landlord. Trust funds by their nature need to be deposited into a trust account in the name of the property manager as trustee.

Accounting provisions in the property management agreement:

- authorize the property manager to pay, out of the income and reserve funds held in the trust account, obligations incurred in the management and ownership of the property;
- specify the bank to be used; and
- call for remaining funds held on behalf of the landlord to be disbursed to the landlord periodically and on termination of the property management agreement.

**Periodic accounting by the manager**

The property management agreement sets the amount of cash reserves the landlord will deposit in the property manager’s trust account as a minimum balance for payment of operating expenses and fees.

A landlord is entitled to a statement of accounting:

- at least once a quarter; and
• when the property management agreement is terminated.²

The property management agreement sets forth the time periods within which the property manager needs to deliver the statement of accounting to the landlord. While not required on a monthly basis, it is most efficient for a property manager to provide a monthly statement to the landlord since they need to reconcile trust account balances for each client once a month. [See Chapter 7]

The accounting provisions also indicate the property manager will disburse to the landlord, with each accounting, any funds exceeding the minimum balance to be held for reserves. The property manager's authority to withdraw their management fee from the trust account is included.

A property manager who fails to give the landlord a timely and accurate accounting faces loss of their real estate broker license on a complaint from the landlord.³

Property managers cannot enforce collection of their management fees without a written agreement with the person agreeing to the payment, typically the landlord.

A prudent property manager will not orally agree with the landlord to the payment of management fees. If the landlord fails to pay fees or interferes with the manager's disbursement of fees, without a signed writing the property manager is unable to enforce their collection.⁴

Thus, the property management agreement sets forth the fees due the property manager.

The property manager needs to also keep all documents connected with any transaction requiring a real estate broker license for three years. These documents include property management and accounting files.⁵

Property managers structure management fee schedules in several different ways:

1. A percentage of the rents collected.
   The property manager is entitled to charge a set percentage of the rents collected as a fee. Customarily, the fee is typically 5% to 10% of the rents collected and is payable monthly. A percentage fee is a proper method for establishing the amount of fees.

2. Fixed fee.
   The property manager and landlord agree in advance to a set dollar amount – a fixed fee – to be charged monthly for management services.

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² Calif. Business and Professions Code §10146
³ Apollo Estates Inc. v. Department of Real Estate (1985) 174 CA3d 625
⁵ Bus & P C §10148
The amount stays constant whether or not the units are rented. This method, while proper, lacks the motivational incentive to induce the property manager to generate maximum rental income.

3. **Fixed fee per unit.**
   Usually applied to large apartment complexes or condominium associations, a set dollar amount is charged for each unit the property manager manages. In addition to the basic fee, property managers often charge a one-time fee each time a unit is re-rented.

4. **A percentage of the first month's rent.**
A front-end fee paid to the property manager is called a **leasing** or **origination fee**. If the landlord agrees, a fee can be charged when any tenant exercises an option to renew or extend, or when the premises is relet to an existing tenant.

Fees are negotiated and set between each individual property manager and landlord.\(^6\)

However, no matter how customary and prevalent it is in the real estate industry to collectively and conscientiously charge a particular percentage fee, fees may not be set by collusion between brokers, or as a result of peer pressure among brokers to maintain equivalent fees. Unfortunately, this conduct still permeates the brokerage industry as a violation of antitrust laws in the form of conscious parallelism.\(^7\)

Developments consisting of condominiums, cooperatives or single family residences (SFRs) in a planned unit development (PUD) are projects called **common interest developments (CIDs)**. Brokers may be retained by the homeowners’ associations (HOAs) of CIDs to manage membership, exercise control over the common areas and structures and account for assessment revenues, expenses and reserves. A broker who acts as a CID manager is called a managing agent.

Before a broker enters into a property management agreement to act as a **managing agent** for a CID, the broker needs to disclose:

- the names and addresses of the owners of the their employing brokerage company if it is an entity;
- the relevant licensing of the owners, such as for architectural design, construction, engineering, real estate or accounting, and the effective dates of the licenses;
- the relevant professional designations held by the owners, what organizations issued the designation, the issuance dates and any expiration dates;\(^8\)
- fidelity insurance sufficient to cover the current year’s operating and reserve funds of the association;
- the possession of any real estate license and whether or not the license is active; and
- if certified to manage CIDs, the name, address and telephone number of the organization issuing the certification, the date the broker was certified and certification status.\(^9\) [See Chapter 6]

Funds received by the managing agent belong to the HOA. If the HOA does not have a bank account, the managing agent will maintain a separate trust fund account as trustee for the HOA funds. Extensive statutory controls are placed on the handling of the trust fund account held for CIDs.\(^10\)

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6. Bus & P C §10147.5
8. CC §5375
9. Bus & P C §11504
10. CC §5380
Upon the sale of any unit in a CID, the managing agent may be required to supply a prospective buyer with documentation of *CID covenants, conditions and restrictions (CC&Rs)* as well as accounting, insurance information and any fees, fines or levies assessed against the seller’s interest in the property. Also, liens against the seller’s interest in the CID unit for any unpaid late fees or accrued interest are disclosed by the managing agent on request prior to the transfer of title.11 [See Figure 2, Form 135]

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11 CC § 4525

**Chapter 7 Summary**

A property management agreement sets out the specific rights, responsibilities and expectations of both the property manager and the landlord. Property management agreements authorize the property manager to handle and account for all income received and expenses incurred in the operation of the property.

Property management agreements also set the fees paid to the property manager, structured as:

- a percentage of the rents collected;
- a fixed fee for the manager’s monthly management services;
- a fixed fee per unit; or
- a percentage of the first month’s rent.

Brokers retained to manage common interest developments (CIDs) are called managing agents. A managing agent needs to perform duties specific to CIDs upon entering into a property management agreement with the homeowners’ association controlling a CID.

**Chapter 7 Key Terms**

- common interest developments ............................................. p. 75
- managing agent ................................................................. p. 75
- property management agreement ........................................ p. 70
After reading this chapter, you will be able to:

- recognize and act on a property manager’s responsibilities and obligations owed the landlord;
- generate a reasonable income from a rental property while maintaining its safety, security and habitability;
- conduct property operations in compliance with the prudent investor standard;
- diligently manage trust accounts for funds received while managing a property; and
- implement a property manager’s best practices in fulfilling the responsibilities of their employment.

**Key Terms**

- commingling
- property profile
- prudent investor standard
- start-up fee
- trust account
- trust funds

**Property management** is an economically viable and personally rewarding real estate service permitted for real estate licensees. Serious brokers and agents often turn their attention from an interest in residential sales to the specialized and more disciplined industry of property management.

A broker’s primary objective as a property manager operating a rental property is to:

- fill vacancies with suitable tenants;
- collect rent;
- incur and pay expenses; and
- account to the landlord.
Thus, a property manager needs to have spent time accumulating experience by actively overseeing and operating like-type rental properties before being entrusted to their management.

Recall that in California, an individual who acts as a property manager on behalf of another for a fee needs to hold a valid California Bureau of Real Estate (CalBRE) broker license. Any licensed agent or broker associate employed by the broker acts on behalf of their broker, not independent of their broker.1 [See Chapter 6]

The duty of care a property manager owes a landlord is the same duty of care and protection a broker in real estate sales owes their sellers and buyers. As a property manager, the broker is an agent acting in capacity of a trustee on behalf of the landlord. Agents acting on behalf of the broker perform property management services as authorized by the broker.

A property manager’s real estate broker license may be revoked or suspended if the property manager demonstrates negligence or incompetence in performing their management tasks. This includes negligent supervision of their employees, be they licensed or unlicensed employees.2

To be successful in the property management field, a broker initially acquires the minimum knowledge and experience through training sufficient to adequately perform their tasks.

A broker acquires property management expertise through:

- courses required to qualify for and maintain a real estate license;3
- on-the-job training as an agent;
- experience as a landlord;
- practical experience in the business management field; and/or
- exposure to related or similar management activities.

Owners measure how capable a broker will be at handling their properties by judging the caliber of the broker’s management skills. Most owners look to hire an experienced property manager with well-earned credentials and a responsive staff who will perform to the landlord’s expectations.

Other indicators that a property manager will successfully handle rental property include:

- prior experience handling and reporting trust account activities;
- a knowledge of current programs used to record and track activity on each property managed by the property manager; and
- a competent staff to perform office and field duties and to quickly respond to both the landlord’s and the tenants’ needs.

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1 Calif. Business and Professions Code §§10130, 10131(b)
2 Bus & P C §§10177(g), 10177(h)
3 Bus & P C §§10153.2, 10170.5
A property manager’s obligations to a landlord include:

- holding a broker license;
- diligently performing the duties of their employment;
- sufficient oversight of the broker’s employees acting on behalf of the landlord;
- handling and accounting for all income and expenses produced by the property;
- contracting for services, repairs and maintenance on the property as authorized;
- monitoring utility services provided by the landlord;
- advertising for prospective tenants;
- showing the property and qualifying tenants;
- negotiating and executing rental and lease agreements;
- responding in a timely manner to the needs of the tenants;
- evaluating rental and lease agreements periodically;
- serving notices on tenants and filing *unlawful detainer (UD)* actions as needed;
- performing regular periodic property inspections; and
- keeping secure any personal property.

In addition to these tasks, the property manager:

- confirms the existence of or obtains general liability and workers’ compensation insurance sufficient to protect the landlord, naming the property manager as an additionally insured;
- obligates the landlord to only those agreements authorized by the landlord;
- maintains the property’s earning power, called *goodwill*;
- hires and fires resident managers and other on-site employees as needed;
- complies with all applicable codes affecting the property; and
- notifies the landlord of any potentially hazardous conditions or criminal activities affecting the health and safety of individuals on or about the property.

A property manager has a duty to employ a higher standard of conduct regarding the operation of a property than a typical landlord might apply. This standard is called the **prudent investor standard**.

A prudent investor is a person who has the knowledge and expertise to determine the wisest conduct for reasonably managing a property. The **prudent investor standard** is the minimum level of competency expected of a property manager by a landlord, whether or not the landlord is familiar with it.
In contrast, the expectations of resident and non-resident landlords may not necessarily be based on obtaining the maximum rental income or incurring only those minimal expenses needed to maintain the long-term income flow of rents from tenants.

Resident owners are more apt to maintain property in a condition which they find personally satisfying, not necessarily in accord with sound economic principles. Often they are not concerned about the effect of the marketplace on their property’s value until it is time to sell or refinance.

Likewise, the landlord may not have the knowledge or expertise to effectively manage the property. Most owners of rental income property pursue unrelated occupations which leave them very little time to concentrate on the management of their properties.

However, property managers are employed to manage property as their primary occupation, one in which they have developed an expertise. A landlord's primary reason for hiring a property manager is to have the property manager maintain the condition of the property at the least cost necessary and keep the rental income stable and as high as the market permits at a reasonable vacancy rate.

Thus, the property manager bases decisions on the need to generate the maximum income from the property and incur only those expenses necessary to maintain the property’s good will and preserve the safety, security and habitability of the property.

To conduct property operations in compliance with the prudent investor standard, a property manager considers the following factors:

- the type of the property and its niche in the market;
- the socioeconomic demographics of the area surrounding the property’s location;
- the competition currently existing in the local market;
- the current physical condition of the property; and
- the existing liens on the property.

The manager's ability to locate tenants willing and able to pay the rent rate sought by the landlord depends on the competition in the area of the property.

For example, when more tenants seek space than there are units available to rent, the property manager may be able to increase the rent (excluding units covered by rent control ordinances) and still maintain occupancy levels.

Conversely, if the number of rental units or spaces available exceeds the quantity of tenants available to occupy them, a property manager has less pricing power. Special programs to better retain tenants and attract new, long-term ones may be necessary to keep the units at optimum levels of occupancy.
The current physical condition (particularly *curb appeal*) of the property reflects the attitude of the ownership towards tenants. A property manager needs to analyze the repairs, maintenance, landscaping and improvements needed to improve the property’s visual appearance and ambiance. Then, they are able to determine the amount of cost involved for any upgrade and the amount of rent increase the upgrades will bring in. The analytical property manager works up a cost-benefits analysis and reviews it with the landlord to consider what will or will not be done.

A prospective tenant’s immediate concern when viewing rental property will be the lure of the landscaping, the freshness of exterior finish and the overall care and tidiness of the premises. More importantly, existing tenants stay or leave based on these observances.

Along with the condition of the property, a property manager operating nonresidential property reviews the status of trust deed liens on the landlord’s property. Both the property manager and the tenants are ultimately affected by the burden existing financing places on the landlord’s cash flow, and possibly the landlord’s ability to retain ownership.

A property manager cannot perform economic miracles for a landlord when payments on the financing encumbering the property are inconsistent with the property’s capacity to generate sufficient rents to produce a positive cash flow after mortgage payments. Worse yet, in some cases mortgage payments may consume such a high percentage of rents as to obstruct payment of maintenance or property management fees.

Also, a thoughtful property manager will apprise the landlord when the opportunity arises in the mortgage market to refinance the property with more advantageously structured financing. The property manager may charge an additional fee for soliciting or arranging financing. [See first tuesday Form 104]

The tenant’s right to possess the property is usually subject to an existing lender’s right to foreclose and terminate the tenancy. A nonresidential tenant’s move-in costs and tenant improvements are at risk of loss if the pre-existing lender forecloses.

It is good practice, and in the property manager’s best interest, to run a cursory title check on the property they intend to manage.

A *title check*, commonly called a *property profile*, is supplied online by title companies. A *property profile* will confirm:

- how ownership is vested and who has authority to employ management;
- the liens on the property and their foreclosure status;
- any use restrictions affecting tenants; and
- comparable sales information for the area.

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**Liens affect nonresidential tenants**

**Title profile analysis avoids surprises**

A report from a title company providing information about a property’s ownership, encumbrances, use restrictions and comparable sales data.
Any discrepancy between information provided by the landlord and a property profile report is resolved with the landlord prior to taking over management of the property.

A property manager’s efforts to locate tenants are documented on a file activity sheet maintained for each property. This paper trail is evidence the property manager has diligently pursued activities leading to the renting and maintenance of the property. Keeping a file activity sheet reduces the risk of claims that the property manager failed to diligently seek tenants or operate the property.

For example, any advertisements placed by the property manager need to focus on and clearly identify the property to be rented. When the advertisement identifies the property, the landlord is properly billed for the expense of the advertisement. Whenever an advertisement is placed, a purchase order is prepared, whether or not the paperwork is given to the publisher or printer.

As in any business, a purchase order contains the dates the advertisement is to run, the advertising copy, which vendor (newspaper or printer) it was placed with and the property to be charged. This billing referencing the purchase order is a written or computer generated reminder to the property manager of their activity and which landlord to charge. Computer programs for bookkeeping provide for the entry, control and printout of this data.

The goal in property management is to make a diligent effort to locate a tenant and rent the property as quickly as possible.

Failing to set or keep appointments to meet with prospective tenants is inexcusable neglect. Prospective tenants do respond to an advertisement. Thus, the property manager or an office employee needs to be available to show them the property, unless the property has a resident or on-site manager.

When the property manager cannot timely perform or complete the management tasks undertaken, they need to delegate some of this workload to administrative employees or resident managers. This delegation is permitted since the property manager is charged with oversight as the responsible supervisor and employer.

A property manager may file a small claims action on behalf of the landlord to recover amounts due and unpaid under a lease or rental agreement if:

- the landlord has retained the property manager under a property management agreement;
- the agreement was not entered into solely to represent the landlord in small claims court; and
- the claim relates to the rental property managed.\(^4\)

\(^{4}\) Calif. Code of Civil Procedure §116.540(h)
A property manager may also file small claims actions to collect money on behalf of a homeowners’ association (HOA) created to manage a common interest development (CID).\(^5\)

However, for the property manager to represent the landlord in a small claims action, the property manager is required to file a declaration in the action stating the property manager:

- is authorized by the landlord to appear on the landlord’s behalf under a property management agreement; and
- is not employed solely to represent the landlord in small claims court.\(^6\)

Consider a licensed real estate broker who operates a property management business as a sole proprietorship under their individual CalBRE broker license. The broker manages an apartment complex for a landlord under a property management agreement.

The property management agreement gives the broker all care and management responsibilities for the complex, including the authority to:

- enter into leases and rental agreements as the landlord;
- file UD actions; and
- hire an attorney to handle evictions, if necessary.

The broker signs all lease and rental agreements in their own name as the landlord under the authority given them in the management contract. The landlord’s name does not appear on any lease or rental agreement as authorized by the terms of the property management agreement.

A tenant of the complex fails to pay rent under a rental agreement entered into with the broker. The broker serves a three-day notice to pay rent or quit the premise on the tenant. [See first tuesday Form 575]

The tenant does not pay the delinquent rent within three days and remains on the premises. The broker files a UD action to recover possession by an eviction of the tenant, appearing as the named plaintiff on the UD complaint.

The tenant defends against the eviction by claiming the broker may not maintain a UD action to evict the tenant since the broker is not the owner of the real estate or the owner’s attorney.

May the broker file and maintain a UD action against the tenant in their own name?

Yes! The broker may file and persecute the UD action even though they are not the true landlord (owner). The broker entered into the lease agreement and delivered possession as the named lessor on the rental or lease agreement, and is now recovering possession from the tenant in their own name as the lessor.\(^7\)

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5 CCP §116.540(i)
6 CCP §116.540(j)
7 Allen v. Dailey (1928) 92 CA 308
As the lessor under the lease, the property manager has the greater right of possession of the premises than the tenant, even though the owner is known by the court to be the true landlord.

Thus, as the lessor named on the lease, the property manager may maintain the UD action against the tenant and recover possession of the premises.

A property manager’s frequent and well-documented inspections of property are nearly as important as their accurate accounting of income and expenses through their trust account. Inspections determine the:

- physical condition of the property;
- availability of habitable units or commercial space; and
- use of the leased premises by existing tenants.

When a property manager conducts an inspection of the property, they do so for one of several key situations:

1. When the property manager and landlord enter into a property management agreement.
   
   Any deferred maintenance or defect which might interfere with the renting of the property is to be discussed with the landlord. The property manager resolves the discrepancy by either correcting the problem or noting it is to be left “as is.” However, conditions which might endanger the health and safety of tenants and their guests may not be left “as-is.”

2. When the property manager rents to a tenant.
   
   A walk-through is conducted with a new tenant prior to giving them occupancy. The property’s condition is noted on a condition of premises addendum form and signed by the tenant. [See first tuesday Form 560]

3. During the term of the lease.
   
   While the tenant is in possession, the property is periodically inspected by the property manager to make sure it is being properly maintained. Notes on the date, time and observations are made in the property management file. File notes are used to refresh the property manager’s memory of the last inspection, order out maintenance and evidence the property manager’s diligence.

4. Two weeks prior to a residential tenant vacating.
   
   Residential property is inspected prior to termination of possession if the tenant requests a joint pre-expiration inspection on receipt of the mandatory notice of right to a wear and tear analysis to be sent by the landlord or the property manager. [See Chapter 14]

5. When the tenant vacates.
   
   The property’s condition is compared against its condition documented when first occupied by the tenant. Based on any differences in the property’s condition, a reasonable amount may be deducted from
the tenant's security deposit for the cost of corrective repairs. Cost deductions are to be documented when accounting for the return of the deposit.

6. When the broker returns management and possession of the property back to the landlord or over to another management firm.

Documenting all property inspections helps avoid disputes with the landlord or tenants regarding the condition of the property when possession or management was transferred to and from the property manager.

The property's condition is noted on a form, such as a condition of property disclosure, and approved by the property manager and the landlord. The property manager keeps a copy in the property's file as part of the paper trail maintained on the property. [See first tuesday Form 304]

Inspections that coincide with key events help establish who is responsible for any deferred maintenance and upkeep or any damage to the property.

On entering into a property management agreement, a broker conducts a comprehensive review of all lease and rental agreement forms used by the landlord, including changes and the use of other forms proposed by the broker.

Also, the competent property manager prepares a worksheet containing the dates of lease expirations, rent adjustments, tenant sales reports, renewal or extension deadlines, and grace periods for rent payments and late charges. Computer programs have made this tracking easier.

Periodic evaluations by the property manager of existing leases and rental agreements are undertaken to minimize expenses and maximize rental income. Vacant units are evaluated to determine the type of tenant and tenancy desired (periodic versus fixed-term), how rents will be established and which units consistently under-perform.

The amount of rental income receipts is directly related to the property manager's evaluation of the rents charged and implementation of any changes. A re-evaluation of rents includes the consideration of factors which influence the amount to charge for rent. These factors include:

- market changes, such as a decrease or increase in the number of tenants competing for a greater or lesser availability of units;
- the physical condition and appearance of the property; and
- the property's location, such as its proximity to employment, shopping, transportation, schools, financial centers, etc.

A property manager's duty includes keeping abreast of market changes which affect the property's future rental rates. With this information, they are able to make the necessary changes when negotiating leases and rental agreements. The more curious and perceptive the property manager
is about tenant demands and available units/spaces as future trends, the more protection the landlord's investment will likely receive against loss of potential income.

**Maintenance and repairs as a responsibility**

Obtaining the highest rents available requires constant maintenance and repair of the property. Possibly, this includes the elimination of physical obsolescence brought on by age. The property manager is responsible for all the maintenance and repairs on the property while employed by the landlord. This responsibility still exists if the property manager delegates the maintenance of the units to the tenants in lease agreements.

The *responsibility for maintenance* includes:

- determining necessary repairs and replacements;
- contracting for repairs and replacements;
- confirming completion of repairs and replacements;
- paying for completed repairs and replacements; and
- advising the landlord about the status of repairs and replacements in a monthly report.

Different types of property require different degrees of maintenance and upkeep. For instance, a commercial or industrial tenant who occupies the entire (nonresidential) property under a net lease agreement will perform all maintenance and upkeep of the property. [See *first tuesday* Form 552-2 and 552-3]

The broker, as the property manager, then has a greatly reduced role in the care and maintenance of the property under a net lease agreement. The property manager simply oversees the tenant to confirm they are caring for the property and otherwise fully performing the terms of the lease agreement.

On the other hand, consider an HOA requirement that maintains common areas for the benefit of the homeowners within a CID. The HOA hires a property manager to undertake these duties. A property manager acting on behalf of an HOA exercises a high degree of control over the maintenance and upkeep of the property and the security of the occupants. The management of a CID is nearly comparable to the management of any other multi-tenant structure, such as an apartment building which has not been converted to a CID.

Usually, landlords set a ceiling on the dollar amount of repairs and maintenance the property manager has authority to incur on behalf of the landlord. The property manager does not exceed this dollar ceiling without the landlord’s consent even though the landlord receives a benefit from the expenditure.
A property manager discloses to their employing landlord any financial benefit the property manager receives from:

- maintenance or repair work done by the property manager’s staff; or
- any other materials purchased or services performed.

When benefitting from repairs, the property manager prepares a repair and maintenance disclosure addendum and attaches it to the property management agreement. This addendum covers information such as:

- the types of repairs and maintenance the manager’s staff will perform;
- hourly charges for jobs performed;
- costs of workers’ compensation and method for charging the landlord;
- any service or handling charges for purchasing parts, materials or supplies (usually a percentage of the cost);
- whether the staff will perform work when they are available and qualified, in lieu of contracting the work out (i.e., no bids will be taken); and
- to what extent repairs and maintenance will generate net revenue for the management company, constituting additional income to the property manager.

To eliminate the risk of accepting undisclosed earnings, the property manager makes a written disclosure of any ownership interests or fee arrangements they may have with vendors performing work, such as landscapers, plumbers, etc.

Undisclosed earnings received by the property manager for work performed by the property manager or others on the landlord’s property are improperly received and can be recovered by the landlord. [See first tuesday Form 119]

Additionally, the landlord may recover any other brokerage fees they have already paid when the property manager improperly or intentionally takes undisclosed earnings while acting as the landlord’s agent.8

The way a property is operated develops a level of **goodwill** with tenants. Economically, **goodwill** equates to the earning power of the property. A property manager in the ordinary course of managing property will concentrate on increasing the intangible image — goodwill — of the property.

Goodwill is maintained, and hopefully increased, when the property manager:

- cares for the appearance of the property;
- maintains an appropriate tenant mix (without employing prohibited discriminatory selection); and
- gives effective and timely attention to the tenants’ concerns.

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8 Jerry v. Bender (1956) 143 CA2d 198

**Earnings from all sources disclosed**

**Goodwill is value maintained or lost**
A prudent property manager makes recommendations to the landlord about maintaining the property to eliminate any accumulated wear and tear, deterioration or obsolescence. Thus, they help enhance the property’s “curb appeal.”

The manager who fails to promptly complete necessary repairs or correctly maintain the property may be impairing the property’s goodwill built up with tenants and the public. Allowing the property or the tenancies to deteriorate will expose the property manager to liability for the decline in revenue.

To accommodate the flow of income and expenditures from the properties and monies they manage, the property manager maintains a trust account in their name, as trustee, at a bank or financial institution.

Generally, a property manager receives a cash deposit as a reserve balance from the landlord. The sum of money includes a **start-up fee**, a cash reserve for costs and the tenants’ security deposits.

A **start-up fee** is usually a flat, one-time management fee charged by the property manager to become sufficiently familiar with the property and its operations to commence management activities.

The cash reserve is a set amount of cash the landlord agrees to maintain as a minimum balance in the broker’s trust account. The cash reserve is used to pay costs incurred when costs and mortgage payments exceed rental income receipts. Security deposit amounts are separate from the client’s cash reserves.

The prudent property manager insists that all security deposits previously collected from existing tenants are deposited into the property manager’s trust account.

The security deposits need to be accounted for separately from other client funds in the trust account, though this separation of a client’s funds is not required. Security deposits belong to the tenant, though the landlord and the property manager have no obligation to handle them differently than funds owned by the landlord.

On a tenant vacating, their deposit is returned, less reasonable deductions. For a residential tenant, an accounting is mailed within 21 days of the tenant’s departure. For nonresidential properties, the security deposit accounting is mailed 30 days after a nonresidential tenant’s departure.\(^9\) [See Chapter 14]

A property manager is required to deposit all funds collected on behalf of a landlord into a trust account within three business days of receipt. These funds are called **trust funds**. Trust funds collected by a property manager include:

- security deposits;

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\(^9\) Calif. Code of Regulations §2830

\(^10\) Calif. Civil Code §1950.5(g)(1); 1950.7(2)(1)

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Chapter 8: A property manager’s responsibilities

• rents;
• cash reserves; and
• start-up fees.\textsuperscript{11}

Again, trust accounts are maintained in accordance with standard accounting procedures. These standards are best met by using computer software designed for property management.\textsuperscript{12}

Also, withdrawals from the trust fund account may not be made by the landlord, only by the property manager.

However, a property manager may give written consent to allow a licensed employee or an unlicensed employee who is bonded to make withdrawals from the trust account.\textsuperscript{13}

No matter who the property manager authorizes to make the withdrawal, the property manager alone is responsible for the accurate daily maintenance of the trust account.\textsuperscript{14}

The property manager’s bookkeeping records for each trust account maintained at a bank or thrift include entries of:

• the amount, date of receipt and source of all trust funds deposited;
• the date the trust funds were deposited in the trust account;
• the date and check number for disbursements of trust funds previously deposited in the trust account; and
• the daily balance of the trust account.\textsuperscript{15}

Entries in the general ledger for the overall trust account are kept in chronological order and in a column format. Ledgers may be maintained in a written journal or one generated by a computer software program.\textsuperscript{16}

In addition to the general ledger of the entire trust account, the property manager maintains a separate subaccount ledger for each landlord they represent. Each subaccount ledger accounts for all trust funds deposited into or disbursed from a separate landlord’s trust account.

Each separate, individual subaccount ledger identifies the parties to each entry and include:

• the date and amount of trust funds deposited;
• the date, check number and amount of each related disbursement from the trust account;
• the date and amount of any interest earned on funds in the trust fund account; and

\begin{itemize}
  \item Bus & P C §10145(a); California Bureau of Real Estate Regulations §2832
  \item CalBRE Reg. §2831
  \item CalBRE Reg. §2834(a)
  \item CalBRE Reg. §2834(c)
  \item CalBRE Reg. §2831(a)
  \item CalBRE Reg. §2831(c)
\end{itemize}
• the total amount of trust funds remaining after each deposit or disbursement from the trust account.\(^{17}\)

Like the general ledger for the entire trust account, entries in each client’s subaccount record are kept in chronological order, in columns and on a written or computer journal/ledger.\(^{18}\)

**Manager’s trust account supervision**

If a property manager or their employees delay the proper maintenance of a trust account, the property manager is in violation of their duty to the landlord to maintain the trust account. This violation places the broker’s license at risk of loss or suspension.

To avoid mishandling of the trust account, the property manager:

• deposits the funds received, whether in cash, check or other form of payment, within three business days;\(^{19}\)

• keeps trust fund account records for three years after the transaction;\(^{20}\)

• keeps a separate ledger or record of deposits and expenditures itemized by each transaction and for each landlord;\(^{21}\) and

• keeps accurate trust account records for all receipts and disbursements.\(^{22}\)

**Accounting to the landlord**

Tied to the property manager’s duty to properly maintain their trust account is the duty to account to the landlord.

All landlords are entitled to a statement of accounting no less than at the end of each calendar quarter (i.e., March, June, September and December).

The accounting is to include the following information:

• the name of the property manager;

• the name of the landlord;

• a description of the services rendered;

• the identification of the trust fund account credited;

• the amount of funds collected to date;

• the amount disbursed to date;

• the amount, if any, of fees paid to field agents or leasing agents;

• the overhead costs; and

• a breakdown of the advertising costs, a copy of the advertisement, the name of the newspaper or publication and the dates the advertisement ran.

Also, the property manager hands the landlord a full accounting when the property management agreement expires or is terminated. Any discrepancy

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17 CalBRE Reg. §2831.1
18 CalBRE Reg. §2831.1(b)
19 CalBRE Reg. §2832
20 Bus & P C §10148
21 CalBRE Reg. §2831.1
22 CalBRE Reg. §2831
or failure by the property manager to properly account for the trust funds will be resolved against them and in favor of the landlord. Even if the property manager’s only breach is sloppy or inaccurate accounting, they are responsible as though misappropriation and commingling occurred.

Although the property manager is required to account to the landlord no less than once each calendar quarter, best practices call for a monthly accounting. They may then rightly collect their fee at the end of each month after they have fully performed and their fee is due. In this way, the property manager avoids the receipt of advance fees. Accounting for the collection of advance fees requires a CalBRE-approved form.23

Again, a property manager on the receipt of monies while acting on behalf of the landlord places them into a trust account. As trust funds, these monies need to be diligently managed to avoid claims of mishandling, misappropriation or the commingling of the landlord’s funds with the property manager’s personal funds.

Consider a landlord who hires a broker to act as a property manager. In addition to paying for expenses and costs incurred, the property manager is instructed and authorized to pay the monthly mortgage payments.

The property manager locates a tenant and collects the initial rent and security deposit. After depositing the funds in the property manager’s trust account, but prior to disbursing the mortgage payment, the property manager withdraws:

- the leasing fee for locating the tenant; and
- the monthly property manager’s fee.

Both fees are due the property manager for work completed under the property management contract.

However, the withdrawal of the property manager’s fees leaves insufficient funds in the trust account to make the authorized mortgage payment. The property manager then issues a check on funds held in one of the property manager’s personal accounts to make the landlord’s mortgage payment. However, this account also has insufficient funds.

Meanwhile, the lender sends the landlord a late payment notice for the mortgage delinquency. The landlord immediately contacts the property manager regarding the delinquent payment. The property manager says they will cover it and does so.

More than three months later, the landlord terminates the property management agreement.

23 Bus & P.C §10146

Handling of trust account funds

**commingling**
The mixing of personal funds with client or other third-party funds required to be held in trust.
Continuing the previous example, the property manager sends a closing statement on the account containing some erroneous deductions. The closing statement is the only accounting the property manager ever prepared for the landlord.

After discussion with the landlord, the property manager corrects the errors in the closing statement, issues the landlord a check for the remaining balance, closes the account and destroys the landlord’s file.

Later, the landlord files a complaint with the CalBRE regarding the property manager’s conduct while under contract.

The CalBRE investigates and concludes the property manager breached their agency duties. The property manager issued a check for a mortgage payment from an account other than the trust account, an activity that automatically constitutes *commingling* of the property manager’s personal funds with trust funds.

Also, the property manager knew they had insufficient funds when they issued the check. This constituted a dishonest act.

In addition, the property manager failed to accurately account for funds taken in or expended on behalf of the landlord. Worse, the property manager neglected their duty to provide an accounting at least every quarter.

Finally, the property manager destroyed the records prior to the expiration of the three-year minimum record keeping requirement. Based on these many violations, the CalBRE properly revokes the property manager’s real estate broker license.24

A broker who operates a real estate sales office, in conjunction with a property management operation, has a potential conflict of interest that may need to be disclosed to their clients.

For example, a creditworthy prospective tenant responding to a rental advertisement might be swayed by the broker’s sales staff to purchase a residence instead of renting. Sales fees are typically greater than leasing fees for the time spent. Conversely, sales fees are one-shot fees, not continuously recurring fees.

Any active attempt to convert a prospective tenant to a buyer when the prospect has responded to a rental advertisement paid for by a landlord or provided as part of the property management services, suggests improper conduct. The broker’s conduct may range from “bait and switch” techniques with prospective tenants to diverting the landlord’s existing tenants through efforts purportedly expended on the landlord’s behalf or interfering with the landlord’s best interests.

A property manager takes care to keep their sales and management operations sufficiently separate from one another. When in contact with a creditworthy

24 *Apollo Estates Inc. v. Department of Real Estate* (1985) 174 CA3d 625
A property manager employs a higher standard of conduct regarding their operation of a property than a typical landlord might, referred to as a prudent investor standard. The property manager applies this higher standard of conduct when:

- overseeing the maintenance of rental property;
- filling vacancies with suitable tenants;
- collecting rents;
- handling trust funds; and
- accounting to the landlord.

All trust accounts are to be maintained in accordance with standard accounting procedures. A property manager needs to be diligent in the management of their trust accounts to avoid claims of mishandling, misappropriation or commingling of funds. The property manager is also required to provide the landlord they represent with a statement of their separate account.

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A broker, retained to manage a residential income property, enters into an employment agreement with a resident manager to oversee the daily management of the property. This employment agreement is called a resident manager agreement. [See Form 591 accompanying this chapter]

Under the resident manager agreement, the resident manager:

- acknowledges employment by the property manager;
- accepts the occupancy and use of an apartment unit rent-free as compensation for the employment; and
- agrees to vacate the property on termination of employment.

The resident manager’s job is to show vacant units, run credit checks, negotiate and sign leases, collect rents, supervise repairs and maintenance, serve notices and perform other non-discretionary administrative activities.
Later, the property manager terminates the resident manager’s employment.

The property manager demands the resident manager immediately vacate the premises and relinquish possession of the unit.

However, the resident manager claims to be a tenant, entitled to a notice and time to vacate, not just a notice terminating employment and their right of possession of the unit. [See Chapter 23]

Is the resident manager entitled to a notice and time to vacate on termination of employment?

No! A resident manager who continues to occupy a unit after their employment is terminated becomes a holdover tenant. They unlawfully detain the unit and have no right to a notice other than the notice terminating their employment. A resident manager’s occupancy is fixed, not periodic. It is established in the resident manager agreement that the resident manager’s tenancy ends on the date their employment is terminated.¹ [See Form 591 §§4.2 and 4.9]

Also, the resident manager’s eviction by an unlawful detainer (UD) action is not protected by rent control ordinances. Further, they may not defend their continued possession by demanding the property manager or landlord show good cause for terminating their employment.²

If the resident manager does not relinquish possession on termination of the resident manager’s employment, the property manager may immediately file a UD action, without further notice, to have the resident manager evicted.

However, a resident manager agreement may provide for the creation of a tenancy following the termination of a resident manager’s employment. When a tenancy is agreed to, the resident manager’s right of possession is not terminated on termination of the resident manager employment, but under landlord-tenant rules of notice before eviction.³

A **resident manager** is an individual employed by the property manager or landlord to live on-site at the managed complex and see to its daily operations. A resident manager’s duties may include:

- screening tenants and negotiating leases;
- cleaning vacated units;
- supervising landscaping, maintenance and repairs;
- serving notices; or
- attending to tenant inquiries.

¹ Karz v. Mecham (1981) 120 CA3d Supp. 1
³ Calif. Code of Civil Procedure §1161(1)
Both residential income property and nonresidential property may have resident managers. However, apartment buildings with 16 or more units are required to have a landlord, resident manager or responsible caretaker living on the premises to manage the property.\footnote{25 Calif. Code of Regulations §42}

Resident managers do not need to be licensed as a real estate broker or agent to negotiate leases or collect rents. However, if a nonresident property manager is not the landlord, the nonresident property manager needs to be licensed by the California Bureau of Real Estate (CalBRE) as a real estate broker.\footnote{Calif. Business and Professions Code §10131.01} [See Chapter 6]

A property manager who employs a resident manager is responsible for the following brokerage activities:

- selecting and hiring the resident manager;
- maintaining worker’s compensation, liability insurance and any bonding requirements of the landlord or property manager;
- keeping payroll records, including information about withholding and employer contributions;
- supervising the resident manager; and
- terminating the resident manager’s employment.

The resident manager’s status as an employee is established in an employment agreement called the resident manager agreement. [See Form 591]

Family members who live with the resident manager are listed in the resident manager agreement. Further, a statement noting these family members are not tenants is to be included. Thus, the family members’ right to occupy the property terminates with the resident manager’s right to occupy the property (e.g., the termination of the resident manager’s employment).

References to the parties in the resident manager agreement need to identify the property manager/landlord as “employer” and the resident manager as “employee.” [See Form 591 §4.9]

Depending on the size of the complex, the resident manager may receive occupancy of a unit in the complex as compensation for their services based on:

- a rent reduction given in exchange for the dollar value of the resident manager’s services;
- no rent charge, the rental value given in exchange for services; or
- no rent charge, plus an additional monthly salary paid in further exchange for services.

The resident manager agreement states the salary paid to the resident manager is a monthly amount. The fair rental value of the resident manager’s
DATE: __________, 20______, at ________________________________________, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:
   1.1 Employer hereby employs ____________________________________________________, as the Employee,
   1.2 as Resident Manager of the rental property commonly referred to as______________________________
   1.3 located at ___________________________ in ___________________________, California,
   1.4 commencing ____________, 20______ and continuing until terminated.

2. EMPLOYEE AGREES TO:
   2.1 Collect all rents, security deposits or other charges due Owner and maintain collection records.
   2.2 Advertise available rental units.
   2.3 Screen and select tenants.
   2.4 Show rental units to prospective tenants.
   2.5 Negotiate, execute or cancel rental or lease agreements with tenants. No lease is to exceed ______ months.
   2.6 Serve three-day notices as needed.
   2.7 Clean, repair and maintain the rental real estate, inside and outside, as needed to promote the occupancy of
   2.8 Daily inspect the structure, grounds, parking lots, garages, and vacant units of the rental property for
   2.9 Maintain receipt books, key racks and petty cash records in good order.
   2.10 Conduct all minor maintenance and repairs not exceeding $_______________ in cost. All materials to be
   purchased out of petty cash.
   2.11 Contact the material and labor suppliers retained by the Employer to conduct all major repairs
   2.12 Notify Employer immediately of any potential hazards to the tenants or property. Should an emergency
   situation arise placing tenants or property in jeopardy, Employee may immediately take action without further
   2.13 Conduct no other business on the premises nor solicit the tenants for any business other than the rental of
   2.14 ___________________________________________________________________________.

3. BANKING:
   3.1 Employee will place all rents, security deposits, and other funds received for the benefit of the Owner into
   3.2 On depositing funds into the Employer’s account, Employee shall deliver to Employer a copy of the bank
   deposit identifying the itemized deposits by the unit from which they were collected.

4. COMPENSATION OF EMPLOYEE AND HOURS WORKED:
   4.1 As compensation for services, Employee shall be paid a total monthly salary, from all sources, of
   4.2 In part, Employee’s salary shall be in the form of possession to rental unit ______, which must be occupied
   as a condition of employment. The rental credit toward the monthly salary is $___________. The fair
   monthly rental value of the unit is $___________. The utilities including gas, electricity, and trash
   removal □ are, □ are not, included with the occupancy.

unit is deducted from their salary. After the rent deduction, the resident
manager is paid any balance of their salary. Utilities may also be included as
part payment for the resident manager's services or treated separately from
the agreed-to salary. [See Form 591 §4]

As an employer, the property manager or landlord is responsible for
withholding and forwarding federal and state income taxes. The property
manager also makes all required payments for social security, unemployment
insurance and disability insurance.6

6 Calif. Unemployment Insurance Code §13020
4.3 The balance of the Employee's salary shall be paid ☐ monthly, ☐ semi-monthly, on the __________ of each calendar month.

4.4 Employee will not work more than ________ hours per day and ________ hours per week.

4.5 Employee to have ________ days off weekly being the weekdays of ____________________________.

4.6 Employee agrees to obtain Employer's consent if the hours required to carry out duties exceeds the agreed-to hours.

4.7 Employee will notify Employer within 48 hours of additional hours worked in an emergency situation.

4.9 Employee acknowledges he is not a tenant, but is an employee for purpose of occupancy of the unit provided for his on-site residency.

4.10 ______________________________________________________________________________________

____________________________________________________________________________________

____________________________________________________________________________________

____________________________________________________________________________________

____________________________________________________________________________________

5. EMPLOYER AGREES TO:

5.1 Hand Employee all keys and entry codes to the property, and copies of rental and lease agreements with existing tenants.

5.2 Provide public liability, property damage and workers' compensation insurance sufficient in amount to protect the Employee and Employer.

5.3 Hand to Employee $___________ to be accounted for as petty cash to pay costs incurred in performing Employee's duties, and to replenish this amount on Employee's request.

5.4 Withhold all Employee's social security, federal and state income taxes, and disability insurance from cash salary paid.

5.5 Pay all federal and state unemployment insurance, workers' compensation and Employer's social security payments.

6. GENERAL PROVISIONS:

6.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

The property manager or landlord is required to carry workers' compensation insurance to cover resident manager injuries on the job. Providing workers' compensation coverage is imperative for any persons who employ individuals other than for casual labor.

The degree of control the property manager or landlord retains over a resident manager classifies the resident manager as an employee. A resident manager simply will not qualify as an independent contractor. Thus, the landlord or property manager who hires a resident manager may not avoid tax withholding, employer contributions or workers' compensation premiums.
Consider a property manager who hires a resident manager to run a large apartment complex. As part of their salary, the resident manager receives a unit rent-free plus a fixed monthly salary.

Is the value of the unit occupied by the resident manager considered income for state or federal tax reporting?

No! Taxwise, the value of the apartment is not reportable income for the resident manager. The reduction or elimination of rent is not declared as income when the unit occupied by the resident manager is:

- located on the premises managed;
- a convenience for the property manager or landlord; and
- occupied by the resident manager as a condition of employment.  

A resident manager’s employment is subject to minimum wage laws even though the portion of the wages paid by a reduction or elimination of rent is not taxable as personal income.  

Minimum wage requirements apply to resident managers. Resident managers carry out the instructions of the property manager or landlord. They do not have the authority to independently make their decisions on their own management policies. They are functionaries who carry out the decisions made at the discretion of the landlord or property manager. 

Even though the rent-free compensation is not taxed as income, the rent credit is included and considered when determining the resident manager’s pay for minimum wage requirements. The rent credit is used as all or part of the wages received per hour of work performed by a resident manager, limited by caps on the rent credit.

Two “caps” limit minimum wage calculations to control the amount of the rent credit. The caps limit the rent credit to two thirds of the fair rental value of the unit and to an amount no greater than $508.38 per month (in 2014). For a couple employed as resident managers, the rent credited toward hourly pay may not exceed $752.02 per month in 2014. 

For example, a broker employs an individual as a resident manager of a 20-unit apartment complex. Later, the resident manager marries and their spouse moves into the resident manager’s unit. The spouse is not employed to manage the residential property.

The following month, the broker subtracts $752.02 from the resident manager’s salary (for the free rent allocation) to calculate the manager’s hourly pay. The broker claims they are now able to deduct the maximum amount for couples since two people inhabit the resident manager’s unit.

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7 26 CFR §1.119-1(b)  
8 Calif. Labor Code §1182.8  
9 8 CCR §11050(1)(B)(1)  
10 8 CCR §11050(10)(C)
The resident manager claims the maximum amount used to calculate their hourly pay is the individual maximum of $508.38 since the spouse was not also employed by the broker.

May the broker use the maximum allowable rent credit for a couple employed as resident managers when the broker employs only one of them?

No! The broker may only calculate the minimum hourly rate based on a total monthly rental credit of $508.38. Only one of the two people residing in the rental unit is employed as a resident manager, the resident manager agreement not modified to also employ the spouse.\(^\text{11}\)

To keep wages per hour from dropping below the minimum dollar amount capped by the government, the property manager requires the resident manager to:

- prepare time cards;
- limit the number of hours per week the resident manager may work so wages per hour do not drop below the minimum dollar amount; and
- make provisions for the payment of any overtime permitted.

By requiring and reviewing these weekly work reports, the property manager may confirm the hours worked by the resident manager and that pay is in line with minimum wage requirements.

These reports will shield the property manager from a resident manager’s claim that they worked excessive hours in relation to their salary and the maximum rent credit allowed. [See Form 591 §4]

Thus, all work requiring additional hours, except emergency work, is to be approved by the property manager as a matter of management policy.

For example, consider a resident manager who is provided with a unit and a base salary. The resident manager is required to remain on the premises at all times. However, they are only authorized to perform required work for a limited number of hours per day. The number of hours is set by the resident manager agreement. [See Form 591 §4.4]

The resident manager claims to be entitled to overtime pay for the hours they are required to remain on the premises even though they are not working.

However, the resident manager is only entitled to receive compensation for the time they actually performed work agreed to in the resident manager agreement. No compensation is due for the time they were required to remain on call, but were not working.\(^\text{12, 13}\)

\(^{11}\) 8 CCR §11050(10)(C)  
\(^{12}\) Brewer v. Patel (1993) 20 CA4th 1017  
\(^{13}\) Ismer v. Falkenberg (March 18, 2008) 160 CA4th 1393
A resident manager has managed a large complex for many years as an agent for the property manager. The resident manager is over 62 years of age.

The property manager hires a new, younger resident manager and relegates the old resident manager to a lesser position. The property manager constantly suggests to the older resident manager that they retire. Further, the property manager demotes the older resident manager to even lesser positions while dramatically reducing their compensation.

Has the property manager discriminated against the older resident manager?

Yes! The property manager’s basis for demoting the older resident manager was age, criteria placing the older resident manager in a protected class.

As a result, the property manager is responsible for monetary losses suffered by the employee for emotional distress and attorney fees. [Stephens v. Coldwell Banker Commercial Group, Inc. (1988) 199 CA3d 1394]

A resident manager is an employee of the property manager or the landlord who hires them. As an employer, the property manager or landlord is liable to others injured due to the resident manager’s negligence.\(^\text{14}\)

To avoid liability for negligent violations of law or personal injuries to others, the conduct of resident managers needs to be closely supervised by the property manager or landlord. Business liability insurance is a necessity for the landlord and the property manager. This insurance covers the landlord and the property manager for the liability exposure created by their own conduct or by the resident manager’s actions.

A resident manager agreement creates an at-will employment between the resident manager and the employing property manager or landlord. Thus, the resident manager’s employment may be terminated at any time and without prior notice.

While a landlord or property manager does not need to have a good reason to terminate a resident manager, they may not have an improper reason for terminating the resident manager. A property manager or landlord may not terminate the resident manager or otherwise harass them based on:

- disability;
- race;
- creed;
- color;
- gender; or
- age.

An improper termination exposes the employing property manager or landlord to liability.\(^\text{15}\) [See Case in point, “An improper termination”]

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\(^{14}\) Calif. Civil Code §2338

\(^{15}\) Stephens v. Coldwell Banker Commercial Group, Inc. (1988) 199 CA3d 1394
Recall from the opening scenario that the resident manager agreement controls the resident manager’s right to occupy their unit as an employee. No separate lease or rental agreement is entered into or required (unless the property manager or landlord specifically intend to create a tenancy).

The resident manager agreement also controls when that right to occupy the unit is terminated. If a resident manager agreement requires the resident manager to surrender their unit upon termination of employment, the resident manager is not entitled to any notice to quit. The termination of employment is sufficient to terminate the resident manager’s occupancy.

If the terminated resident manager remains in possession of the property after their employment is terminated, they are unlawfully detaining the property and may be evicted.

*Editor’s note — Under rent control ordinances, a holdover tenant needs to receive a notice to vacate to terminate the tenancy. However, courts in rent-controlled areas have exempted employee-tenants from rent control protection by classifying them, for purposes of rent control only, as licensees rather than tenants. They are not considered licensees for any other purposes.*

To avoid creating a tenancy that continues on termination of the resident manager’s employment, the resident manager agreement will state:

- possession is incidental to employment;
- possession automatically ends concurrent with termination of employment; and
- failure to perform managerial duties constitutes a breach of the resident manager agreement and is grounds for immediate termination and eviction.

However, a caution: a property manager or landlord’s conduct can change the resident manager’s right of occupancy.

Consider the landlord of an apartment complex who hires a resident manager to run the complex. In exchange for their services, the resident manager receives a monthly salary and an apartment, rent-free.

Under the resident manager agreement, the resident manager is to vacate the apartment unit on termination of their employment. Thus, the right of possession is extinguished when employment is terminated.

The landlord terminates the resident manager’s employment. The landlord then decides to serve the resident manager with notice to:

- immediately vacate and relinquish possession of the unit; or
- stay and pay monthly rent.

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The resident manager remains in possession of the apartment, but fails to also pay the monthly rent called for in the notice to quit. Without further notice, the landlord begins UD proceedings to regain possession of the apartment from the terminated resident manager.

The resident manager claims that due to the notice they are now a tenant and the landlord needs to serve them with a notice to quit before the landlord may evict the resident manager in a UD action.

The landlord claims the resident manager is a holdover tenant unlawfully detaining the premises since the termination of their employment.

Is the resident manager entitled to a notice to vacate?

Yes! By serving the resident manager with a notice to quit which included an offer to remain in possession, the property manager converted the resident manager’s occupancy as an employee to a month-to-month tenancy.

Here, the resident manager’s continued occupancy of the apartment constituted acceptance of the new tenancy offered by the landlord. The failure to pay rent is merely a breach of the new tenancy agreement noted in the notice to stay and pay.

Thus, the landlord’s UD action may not be filed until proper notice to vacate is given to terminate the resident manager’s new tenancy.\(^{17}\)

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\(^{17}\) Kitz. supra; CC §1946

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A resident manager is an individual employed by a property manager to live on-site at the managed property and see to its daily operations. A property manager and a resident manager have an employer/employee relationship. A resident manager’s duties include:

- screening tenants and negotiating leases;
- cleaning vacated units;
- supervising landscaping, maintenance and repairs;
- serving notices; or
- attending to tenant inquiries.

The resident manager may receive rent-free occupancy of a unit in the complex as compensation for their services. Taxwise, the value of the apartment is not reportable income for the resident manager. In contrast, a resident manager’s employment is subject to minimum wage laws.

The property manager is liable to others injured due to the resident manager’s negligence. The resident manager’s employment may be terminated at any time and without prior notice. A resident manager agreement may require the resident manager to surrender their unit upon termination of employment.
Notes:
Identification of property manager or owner

After reading this chapter, you will be able to:

• authorize brokers under an agent-for-service clause in management agreements to act on behalf of an owner to accept service of legal documents and notices from tenants;
• appoint an agent-for-service; and
• determine the disclosures to be given to residential tenants identifying the owner, the property manager and the owner’s agent-for-service.

An owner of a residential income property employs a broker to manage the property. The broker will operate the property acting as the landlord under the property management agreement, which includes all contact with the tenants on behalf of the owner. [See Chapter 7]

One of the owner’s objectives is to become as anonymous as possible and avoid giving tenants any personal information or otherwise interacting with them.

The owner is advised they can avoid being identified to the tenants by appointing another individual to act as their agent-for-service of process, such as the broker or the owner’s attorney. The agent-for-service of process, acting on behalf of the owner, will accept service of legal documents and notices initiated by tenants.¹

¹ Calif. Civil Code §1962(a)(1)(B)
Here, when the owner appoints an agent-for-service of process, the owner’s name and address need not be disclosed to any tenant, even if the tenant demands the information so they can sue the owner. Serving the agent-for-service with the lawsuit is the same as serving the owner.²

Editor’s note — The identity of an owner is easily located by a search of the county records. If title to the property is vested in the name of a limited liability company (LLC), corporation, or other entity, a review of other records with the Secretary of State will identify and locate the manager of the entity.

An owner is the object of the service of notices and legal documents by a tenant. However, a residential income property owner may appoint any individual, including their property manager or attorney, to be their agent-for-service. Importantly, this appointment allows the owner to avoid personal service on themselves.

The property manager may be appointed as the owner’s agent-for-service by including an agent-for-service clause in the property management agreement employing the broker. [See first tuesday Form 590]

As the owner’s agent-for-service, the broker accepts personal service of legal documents on behalf of the owner, such as notices and lawsuits initiated by tenants. However, both the broker and the owner need to first consider whether it is prudent for the broker to act as the owner’s agent-for-service.

The broker’s additional responsibility of accepting service of tenant complaints on the owner’s behalf conflicts with the broker’s main responsibility as a property manager. An owner might prefer to appoint an attorney as their agent-for-service to avoid the broker’s potential conflict of interest.

The names and addresses of the following individuals will be disclosed to all residential tenants:

• the owner or other individual appointed by the owner as their agent-for-service;
• any property manager; and
• any resident manager.³

The addresses provided for the property manager, resident manager and agent-for-service are street addresses where legal notices can be personally served. A post office box will not suffice.⁴

The individual responsible for making the disclosures is:

• the owner; or
• the individual authorized to enter into rental and lease agreements on behalf of the owner, such as the property manager or resident manager.⁵

² CC §1962(a)(1)(B)
³ CC §1962(a)
⁴ CC §1962(a)(1)
⁵ CC §1962(a)
The names and addresses of the owner’s property manager, the resident manager and agent-for-service are disclosed in:

- the rental and lease agreements entered into with each tenant; or
- a notice posted on the property.6

When the disclosure notice is posted, the notice will be posted in two conspicuous places on the property.7

If the rental property contains elevators, the written notice will be posted in:

- every elevator in the building; and
- one other conspicuous place on the property.8

If the residential rental or lease agreement is oral, a written statement containing the names and addresses of the property manager, resident manager and agent-for-service will be provided to all tenants.9

The owner, property manager or resident manager responsible for entering into rental and lease agreements is to notify all tenants of the name and address for service on the owner of a notice or complaint initiated by the tenant. This information is handed to the tenants within 15 calendar days after any change in:

- the manager of the property;
- the owner of the property, unless the new owner appoints an agent-for-service; or
- the owner’s agent-for-service.10 [See Form 554 accompanying this chapter]

To disclose a change in ownership or management, the property manager or resident manager responsible for leasing is to:

- prepare the notice of change of ownership or property management as an addendum to each existing rental or lease agreement and hand it to each tenant to sign and return [See Form 554]; or
- post on the property the names and addresses of the property manager, resident manager and owner’s agent-for-service.

The notice also includes information regarding how and when rent will be paid. A successor owner or property manager may not serve a tenant with a notice to pay rent or quit, or file an unlawful detainer action based on rent unpaid and due during the period in which the successor owner or property manager failed to provide rent payment information.11

However, the owner or property manager’s failure to timely provide rent payment information does not excuse a tenant of their obligation to pay rent.

6 CC §1962(a); CC §1962.5(a)
7 CC §1962.5(a)(2)
8 CC §1962.5(a)(1)
9 CC §1962(b)
10 CC §1962(b)
11 CC §1962(c)
A residential property manager (or resident manager) in charge of leasing who fails to provide the name and address of the owner or their agent-for-service:

- automatically becomes the owner’s agent-for-service of process and agent for receipt of all tenant notices and demands\(^\text{12}\); and

\(^{12}\) CC §1962(d)(1)
is treated as the owner, not the owner’s agent, and liable for performing all obligations described under rental and lease agreements with tenants. 13

When the person signing the lease or rental agreement for the owner fails to make the disclosures, the tenant may have no indication the person signing is not the owner. However, this does not relieve the owner of liability to tenants. It merely extends liability to the property manager or resident manager who failed to give the required agency notice identifying themselves as agent for the owner. 14
Chapter 10 Summary

An agent-for-service of process may act on behalf of the owner, accepting service of legal documents and notices initiated by tenants. The agent-for-service provision in a property management agreement identifies the individual acting in this capacity.

The owner, property manager and resident manager disclose their addresses to all residential tenants and how and when rent is to be paid in notices handed to the tenants.

Failure to disclose imposes liability for tenant claims on the property manager and the resident manager.

Chapter 10 Key Terms

- agent-for-service clause ................................................. pg. 108
- agent-for-service of process ........................................... pg. 107
Chapter 11: Exclusive authorization to lease

After reading this chapter, you will be able to:

• understand the broker’s right to compensation for services when employed by a nonresidential owner under an exclusive authorization to lease;
• use a fee schedule to establish the broker’s right to a fee for future extensions, renewals and other continuing leasehold and purchase arrangements which might be later entered into by the tenant and the owner;
• distinguish the various provisions in an authorization to lease which protect the leasing agent’s fee; and
• identify situations in which the leasing agent/broker has earned a fee.

A nonresidential property is offered for lease by the owner. A broker makes an appointment with the owner to discuss the possibility of becoming their leasing agent.

During the discussion, the broker explains they can best help lease the property when operating under an exclusive authorization to lease, also called a listing or employment agreement.
Under the listing, the broker, on the owner’s behalf, will be able to:

- market the space and locate prospective tenants [See Figure 1, Form 110 §1];
- publish the terms under which a tenant can lease and occupy the space [See Figure 1, Form 110 §8];
- share fees with brokers representing the tenants [See Figure 1, Form 110 §4.2];
- conduct negotiations with tenants or their brokers [See Figure 1, Form 110 §4.3]; and
- accept deposits with offers to lease the space.

A broker who acts solely as a leasing agent does not manage or operate the property for the owner. The duties of a leasing agent are limited to locating prospective tenants and negotiating a lease agreement for their occupancy of the space.

**Right to compensation for services**

An *exclusive authorization to lease* entered into by the owner assures the leasing agent they will be paid a fee for their efforts if anyone procures a tenant for the identified space during the listing period, either on:

- the leasing terms sought in the listing; or
- any other terms accepted by the owner.

However, an owner may be reluctant to give up the ability to lease the property independently. Further, an owner may want to avoid employing a leasing agent and paying a brokerage fee if the owner locates the tenant.

On the other hand, an owner has a better chance of finding a tenant on acceptable terms if they employ a leasing agent that is known in the community of local leasing agents. An effective leasing agent takes the owner’s “rough edges” out of negotiations and is constantly involved in leasing discussions with others in the trade.

**Written authorization to lease**

Consider an owner who prefers to orally agree to employ a broker to find tenants for the owner’s property. The owner confirms they will work exclusively with the leasing agent to market the space and locate a user. The owner does not, however, believe it is necessary to commit all these arrangements to a written agreement.

The broker explains an *exclusive authorization to lease* must be written and signed by the owner for the broker to be entitled to collect a fee. No signed writing, no services.

**Is the broker correct?**

Yes! A written agreement signed by the client is the only way a broker can protect their right to compensation for services. More importantly, a written
agreement memorializes the leasing agent’s obligation to conscientiously and continuously work to meet the client’s objectives, whether representing a tenant or an owner.

An oral fee agreement between a broker and their client is unenforceable by the broker and leaves the broker without evidence of the agency created. This is true even when the broker documents the existence of an oral agreement.
by referencing the fee and terms of payment in written correspondence sent to and acted on by the client. Without the client’s signature promising to pay, the broker cannot enforce collection of the orally promised fee.¹

Thus, a broker protects their right to collect a fee by entering into a form exclusive authorization to lease, signed by the owner, before performing any services.

Editor’s note — If a broker is employed under an oral agreement to renegotiate an existing lease, the employment agreement does not need to be in the form of a signed written agreement to collect the promised fee.

Fees promised a broker for negotiating of modifications, space expansions, extensions or renewals of existing leases are not required to be written to be enforceable. Here, the lease has already been created, taking the further employment out from under the statute requiring a writing to enforce fee agreements.²

An exclusive authorization to lease operates like an exclusive right-to-sell listing agreement.

The leasing agent is employed to “sell the use,” a leasehold interest with the right of possession, by locating a user for the owner’s property. This is comparable to employment of a seller’s agent to “sell the ownership” by locating a buyer for a property.

The broker owes the same obligations and duties to the owner under an exclusive authorization to lease as they owe a seller under an exclusive right-to-sell listing. As a leasing agent, the broker’s primary obligation owed an owner seeking tenants is to diligently, consistently and conscientiously market the property and locate qualified tenants.

Conversely, a leasing agent’s performance under a written open listing requires only the broker’s best efforts to locate a tenant, not constant diligence. An open listing sets the leasing agent in competition with the owner and other brokers to locate a tenant and collect a fee.

An exclusive authorization-to-lease calls for the preparation of a fee schedule. The fee schedule is attached to the exclusive authorization and references leasing situations which trigger the broker’s right to be paid a fee when earned. The fee schedule includes fees for future extensions, renewals and other continuing leasehold and purchase arrangements which might be entered into in the future by the tenant and the owner. [See first tuesday Form 113; see Chapter 30]

The amounts established in the fee schedule are earned and due to the broker when:

• an exclusive right-to-collect clause assures payment of the agreed-to fee if anyone procures a tenant on the terms in the listing, or on any other terms accepted by the owner [See Figure 1, Form 110 §3.1a];

² Shell v. Darnelle (1984) 162 CA3d 957
• an *early termination clause* assurs payment of the fee if the owner withdraw the property from the rental market during the listing period [See Figure 1, Form 110 §3.1b];

• a *termination-of-agency clause* assurs payment of the fee if the owner cancels the employment without cause before it expires under the listing, whether or not the owner intends to continue to market the property for sale [See Figure 1, Form 110 §3.1c]; and

• a *safety clause* assurs payment of the fee if, within one year after termination of the exclusive authorization to lease, the owner enters into negotiations resulting in a leasing or sale of the property to a prospective tenant the broker negotiated with during the listing period. [See Figure 1, Form 110 §3.1d]

Now consider a broker who is employed by an owner under an exclusive authorization to lease.

The authorization states the owner will pay the broker a fee if the broker, or anyone else, produces a tenant ready, willing and able to lease the property on the same terms specified in the exclusive authorization to lease. [See Figure 1, Form 110 §3.1a]

The broker produces a creditworthy tenant who is financially capable of leasing the premises on the terms set forth in the exclusive authorization to lease. [See Figure 1, Form 110 §8]

The broker prepares and submits the tenant’s offer to lease on terms substantially identical to the leasing terms in the authorization, called a *full listing offer to lease*. [See *first tuesday* Form 556]

The owner then demands higher rental rates and refuses to accept the offer.

The broker claims to be entitled to a fee since they produced a tenant who was ready, willing and able to lease the property on the terms stated in the exclusive authorization to lease.

The owner claims the broker is not entitled to a fee since the property was never leased.

Here, the broker has earned their fee. The exclusive authorization to lease included a written fee agreement obligating the owner to pay the broker a fee once the broker located a tenant ready, willing and able to lease the property on the terms set forth in the exclusive authorization to lease.3

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3 Twogood *v.* Monnette (1923) 191 C 103
Now consider a broker whose exclusive authorization to lease contains a fee provision that states they are entitled to a fee if the owner rents the space during the listing period. This clause is called the exclusive right-to-collect clause. It is the exclusive right-to-collect clause which makes a listing exclusive. The clause states “a fee is due if anyone procures a tenant.”

The broker, as part of their efforts to locate a tenant, places a “For Lease” sign on the premises. The sign is seen by a prospective tenant.

The prospective tenant contacts the owner of the premises directly.

Before the exclusive authorization to lease period expires, the prospective tenant and owner enter into a lease agreement. The terms of the lease agreement are different from those specified in the broker’s exclusive authorization to lease.

Even though the owner’s broker had no contact with the prospective tenant (other than the sign exposure) and the terms are different from the listing, the broker has earned a fee. A tenant’s offer to lease was accepted by the owner during the exclusive authorization period.

A typical exclusive authorization to lease contains boilerplate wording in the fee provision stating the owner will pay the broker the agreed-to fee if the property is:

- withdrawn from the rental market;
- transferred or conveyed;
- leased without the broker’s consent; or
- otherwise made unrentable by the owner.

Collectively, this boilerplate provision is known as the early termination clause. An early termination clause protects the broker from loss of time and money spent in a diligent effort to locate a tenant when the owner’s conduct effectively removes the property from the rental market before the listing expires. When the owner interferes with the broker’s objective — to produce a ready, willing and able tenant on the terms stated — a fee has been earned and is immediately due.

Consider a broker and owner who enter into an exclusive authorization to lease that expires in six months. The agreement contains a fee provision with an early-termination clause.

The broker diligently attempts to locate a tenant for the owner’s property.

During the listing period, the owner notifies the broker the property is no longer for lease. The broker is instructed to stop marketing the property. In compliance with the owner’s instructions, the broker takes the property off the market.

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4 Carlsen v. Zane (1968) 261 CA2d 399
The broker then makes a demand on the owner for a full listing fee. The broker claims the early termination clause provides for payment of the broker’s fee by the owner when the owner withdraws the property from the rental market before the listing period expires.

The owner claims the broker cannot collect a fee under the early termination clause since it is an unenforceable penalty provision.

Is the broker entitled to a fee on the client’s termination of the broker’s employment?

Yes! The broker is entitled to a fee. The early termination clause is not a penalty provision since the owner has an alternative. It simply gives the owner the option to cancel the exclusive authorization agreement in exchange for paying the broker a fee instead of allowing the listing to expire without interference with the broker’s marketing efforts. The owner exercises the right to cancel by conduct which interferes with the broker’s ability to lease the property, such as taking the property off the market. Thus, the owner is required to pay the fee on exercise of their option to cancel the listing agreement.5

Editor’s note — See first tuesday Form 121 for an agreement to cancel an exclusive authorization to lease during the listing period.

A safety clause protects a leasing agent’s fee when their efforts produce results during the year after the listing expires. This one-year period is known as the safety clause period. [See Figure 1, Form 110 §3.1d]

Under the safety clause, the owner owes the leasing agent the scheduled fee if:

• during the safety clause period, the owner enters into negotiations with a tenant located by the leasing agent during the listing period; and
• the negotiations result in a lease agreement.

The safety clause includes a provision which calls for the leasing agent as a condition precedent to collecting a fee to provide the owner with a list of the prospective tenants located by the leasing agent during the listing period. [See first tuesday Form 122]

Consider a broker and an owner who enter into an exclusive authorization to lease. The exclusive authorization to lease contains a fee provision with a safety clause.

On expiration of the listing period, the broker supplies the owner with the names of prospective tenants they have contacted and who received information regarding the property. Thus, each of these prospective tenants is “registered” with the owner.

5 Blank v. Borden (1974) 11 C3d 963
After the listing expires, the owner employs a second broker without discussing the terms of the prior listing.

Within the safety period of the first broker’s listing, the second broker leases the premises to a tenant registered by the first broker. The lease is arranged without the first broker’s participation in negotiations or the fee paid on the transaction.

Here, the owner owes the first broker the entire amount of the agreed-to fee even though the property was leased while listed exclusively with another broker.

The exclusive authorization to lease entered into by the owner and the first broker promised the first broker a fee if, within one year after expiration of the listing, the owner enters into negotiations which result in a lease with a prospective tenant registered with the owner by the first broker.6

As a “safety net” for brokerage services rendered, the clause discourages the owner from attempting to avoid payment of a leasing agent’s fee by:

- waiting until the exclusive authorization agreement expires and then directly or indirectly approaching a prospective tenant located and solicited by the leasing agent; or
- making special fee arrangements with a second leasing agent which re-ignite negotiations with a prospective tenant located and exposed to the property by the first leasing agent broker.

An offer-to-lease form is used by prospective tenants to begin negotiations with the owner to lease a property. Along with a prospective tenant’s desired lease terms, offer-to-lease forms typically contain a provision stating the broker’s fee is payable on the transfer of possession to the tenant. This provision is called a contingency fee clause. [See first tuesday Form 556]

Consider an owner who accepts an offer to lease submitted by a broker on behalf of a prospective tenant. The signed offer to lease contains a fee provision which states the broker’s fee is payable by the owner on change of possession. [See first tuesday Form 556]

Later, the owner wrongfully refuses to enter into a lease agreement and convey the leasehold interest as agreed in the offer to lease. The broker makes a demand on the owner for payment of a fee.

The owner claims the broker is not entitled to receive a fee since the leasehold was never conveyed to the prospective tenant.

Is the broker entitled to their fee?

Yes! The owner cannot avoid paying the fee the broker has already earned by claiming a lease was never signed. Here, the owner’s breach of the agreement to lease prevented the transfer of occupancy to the tenant. The owner failed
to deliver the lease agreement and possession as agreed in the offer to lease. Thus, the failure to enter into the lease triggers payment of the fee previously earned when the owner accepted the tenant’s offer to lease.

The contingency fee clause included in the offer to lease merely designates the time for payment of a fee the broker previously earned on locating a tenant or the acceptance of the tenant’s offer. The contingency fee clause in the offer does not defeat the broker’s right to compensation simply because the owner later wrongfully refused to enter into the lease.7

The contingency fee clause in an offer to lease shifts the time for payment of the fee from the time the fee is earned under an exclusive authorization agreement to the time a lease is entered into in the offer to lease.

Also, unless the leasing agent approves, the owner cannot include and enforce a fee provision in the offer to lease that is unacceptable to the broker or contrary to the terms of the fee schedule in the exclusive authorization to lease.8

Exclusive authorizations to lease have fee schedules attached which contain formulas for calculating the brokerage fee earned based on the length of the lease negotiated with the tenant. Further, they usually state the broker will receive an additional fee for any extension, renewal or modification of the tenant’s occupancy under the original lease. [See Chapter 30]

For example, a broker operating under the authority of a written exclusive authorization to lease procures a tenant who signs a ten-year lease. The broker is paid the fee called for in the listing agreement fee schedule.

The fee schedule also provides for a percentage fee to be paid if the owner and tenant enter into an agreement for the tenant’s continued occupancy of the premises on expiration of the original lease.

On expiration of the original lease, the owner and tenant negotiate a new lease for the tenant’s continuing occupancy and use of the premises. A brokerage fee is not paid for the tenant’s continued occupancy.

The broker makes a demand for an additional fee under the original listing agreement. The broker claims the new lease, which the broker did not negotiate, earned the broker a fee.

The owner claims they do not owe the broker a fee since the new lease is a separate agreement, not an extension, renewal or modification of the original lease.

However, the broker is due an additional fee from the owner as agreed in the original listing since the new lease constitutes an extension of the original possession.

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7 Steve Schmidt & Co. v. Berry (1986) 183 CA3d 1299
8 Seck v. Fouika (1972) 25 CA3d 556
Here, the tenant located by the broker continued in possession and use of the premises on expiration of the original lease. The listing agreement stated the broker was to be paid a fee on this event. The form of documentation used to permit the continued occupancy of the premises is of no importance.⁹


Chapter 11
Summary

An exclusive authorization to lease entered into by the owner assures the leasing agent will be paid a fee for their efforts if anyone procures a tenant for the identified space during the listing period, either on:

- the leasing terms sought in the listing; or
- any other terms accepted by the owner.

An exclusive authorization-to-lease calls for the preparation of a fee schedule. The fee schedule is attached to the exclusive authorization and references leasing situations which trigger the broker’s right to be paid a fee when earned. The fee schedule includes fees for future extensions, renewals and other continuing leasehold and purchase arrangements which might later be entered into by the tenant and the owner.

Numerous provisions exist in the exclusive authorization to lease which protect a leasing agent’s right to a fee, including the:

- exclusive right-to-collect clause;
- early termination clause;
- safety clause; and
- contingency fee clause.

Chapter 11
Key Terms

contingency fee clause ............................................................... pg. 120
early termination clause ........................................................... pg. 118
exclusive authorization to lease ............................................... pg. 114
exclusive right-to-collect clause ............................................... pg. 118
full listing offer to lease .......................................................... pg. 117
leasing agent ............................................................................. pg. 113
open listing ................................................................................ pg. 116
safety clause ............................................................................ pg. 119
termination-of-agency clause .................................................... pg. 117
Chapter 12: Exclusive authorization to locate space

After reading this chapter, you will be able to:

• use an exclusive authorization to locate space to assure payment of a fee for assisting prospective tenants;
• determine a tenant’s needs and expectations for leasing a property using a tenant lease worksheet; and
• understand the benefits for prospective tenants and brokers employed under an exclusive listing agreement.

A landlord of a nonresidential property holds an open house attended by leasing agents. The purpose of the open house is to induce the leasing agents to locate tenants for the landlord’s vacant space.

Leasing agents attending the open house are handed the landlord’s brochure on available space and lease terms. The information includes an unsigned schedule of broker’s fees the landlord will pay if a broker procures a tenant who leases space in the property. The informational handout also includes a tenant registration form for brokers to fill out when showing the space to prospective tenants.

One of the brokers who received a brochure inspects the property with their client, a prospective tenant.
To effectively negotiate a nonresidential lease arrangement on behalf of a tenant, a leasing agent needs to possess a high level of knowledge and expertise regarding the alternative terms of a lease agreement. Further, to select qualifying space and negotiate the best terms for a tenant, the agent first identifies the tenant’s needs and expectations for leasing a property.

When gathering leasing information from a tenant, the agent needs a checklist of pertinent items to consider. This objective is best met by using a tenant lease worksheet. [See first tuesday Form 555]

In the process, the leasing agent needs to uncover the tenant’s precise reasons for moving to be better equipped to find a suitable new location and premises, or possibly negotiate a renewal or extension of the tenant’s existing lease.

Know the tenant’s business projections

When a prospective tenant is starting a new business, the leasing agent initially needs information on the tenant’s business projections, which may be overly optimistic. The tenant may want space that is simply too large or in too expensive a location. The tenant may have to settle for incubator space in a less desirable location which accepts “start-up” business tenants.

Conversely, a tenant may underestimate the potential future growth of their business. The premises they favor may be too small to accommodate their short-term growth, hindering attempts to expand. The tenant will be forced to relocate again prematurely. To ensure room for future growth, the leasing agent considers:

- options to lease space;
- the right of first refusal on additional space; or
- a lease cancellation or buyout provision to vacate the premises.

The broker completes the tenant registration form identifying the broker and prospective tenant. The registration form itself does not reference the fee schedule or any amount payable to the broker as a fee.

The registration form is handed to the landlord, or the landlord’s employee, who signs it and returns a copy to the broker.

Later, the broker prepares an offer to lease, which is signed by the tenant and submitted to the landlord. The offer to lease form contains a provision calling for the landlord to pay a broker’s fee. [See Form 556 §15 in Chapter 11]

The offer to lease is not accepted or rejected by the landlord. The landlord does not make a counteroffer. However, without contacting the broker, the landlord and the tenant engage directly in lease negotiations. Later, they enter into a lease which does not provide for a fee to be paid to the broker.

In the lease, the landlord agrees to be responsible for payment of any broker’s fee due as a result of the lease.
Chapter 12: Exclusive authorization to locate space

Also, over projection of the potential income of a tenant’s business under a percentage-rent lease agreement will reduce the landlord’s projected rental income. Unless the leasing agent considers the space needs and gross income of the tenant, the leasing agent’s long-term service to either the landlord or tenant is limited. Thus, the leasing agent needs to consider a system to help them match up the right landlord with the right tenant.

Using a tenant lease worksheet

The tenant lease worksheet covers three key areas the leasing agent is to consider:

• the tenant’s lease agreement obligations for their existing space;
• the tenant’s present and future needs for leased space; and
• the tenant’s financial condition and creditworthiness for ability and capacity to make rent payments. [See first tuesday Form 555]

Regarding the tenant’s space requirements, the leasing agent considers:

• current square footage needs;
• future square footage needs;
• phone, utilities, computer and information technology (IT) needs;
• heating and air conditioning requirements;
• parking, docking, turn-around and shipping requirements;
• access to freeways, airports and other public transportation;
• access to civic, financial, legal, governmental or other “downtown” facilities;
• response time for police and fire departments;
• access to housing areas; and
• any needs peculiar to the tenant.

Some tenants focus on specific geographic locations among businesses or in population centers. Others may need the lowest rent possible, regardless of location.

On discovering the tenant’s occupancy, the broker seeks payment of their fee from their client the tenant, not the landlord. The broker claims the tenant interfered with or breached the broker’s fee provision in the offer to lease (which was signed by the tenant) by failing to provide for payment of the fee the broker earned when the tenant leased the property.

The tenant claims they are not liable for payment of the broker’s fee since the offer to lease called for the landlord to pay the broker’s fee.

Can the broker recover their fee from the tenant?

Yes! The offer to lease signed by the tenant contains a fee provision which states the broker will receive compensation for their efforts if the tenant leases the premises. It is not important that the tenant’s offer called for the landlord to pay the fee.

Thus, the broker is able to enforce collection of a fee from the tenant. The tenant signed an offer to lease the property, which contained a provision.
calling for the broker to be paid a fee. The tenant breached that fee provision by failing to provide for payment of that broker’s fee. In doing so, the tenant incurred liability for the fee.¹

Conversely, a broker locating space for a client puts their fee orally promised by the landlord at risk if the prospective tenant does not sign an agreement — such as an exclusive authorization to locate space or offer to lease — containing provisions for the payment of a broker’s fee if the tenant leases property. An oral agreement to pay a broker’s fee is unenforceable against the person making the oral promise.²

A leasing agent has the opportunity to enter into a written fee agreement signed by either the tenant or the landlord on at least four occasions during lease negotiations:

- when the leasing agent solicits a nonresidential landlord for authorization to represent the landlord to locate users and negotiate acceptable leasing arrangements; [See Form 110 in Chapter 11]
- when the leasing agent solicits (or is solicited by) a nonresidential tenant for authorization to represent the tenant to locate suitable space and negotiate leasing arrangements acceptable to the tenant; [See Form 111 accompanying this chapter]
- when the leasing agent prepares a tenant’s offer to lease by including a broker’s fee provision within the body of the offer signed by the tenant; and
- when the leasing agent prepares the lease agreement by including provisions for fees.

A broker needs to enter into an employment agreement with a tenant before extensively analyzing the tenant’s needs for space the broker intends to locate. The employment agreement is entered into and signed prior to locating space or exposing the tenant to available space not listed with the broker. [See Form 111]

This employment agreement, called an exclusive authorization to locate space, assures the broker a fee will be received if the tenant ultimately leases space of the type and in the area noted in the authorization. Through the exclusive authorization, the tenant commits to work with the broker to accomplish the objective of the employment — to rent space. The leasing agent’s commitment to the tenant under the employment is a promise to use diligence and care in locating suitable space on terms acceptable to the tenant.

The exclusive authorization to locate space form is similar in structure and purpose to a exclusive authorization to lease entered into by a landlord and includes:

- the term of the retainer period;

¹ Rader Company v. Stone (1986) 178 CA3d 10
the formula for calculating the broker's compensation and who will pay the fee [See Form 113 in Chapter 30];

- a description of the type and location of space or property sought by the tenant; and

- identification of the broker as the agent and the tenant as the client.
The description of the property in the exclusive authorization to locate space specifies the space requirements, location, rental range, terms and other property conditions sought by the tenant.

Based on the fee provisions in an exclusive authorization to locate space, the broker earns a fee when the tenant enters into a lease agreement for space similar to the space sought under the exclusive authorization. The fee is collectible no matter who locates acceptable space or negotiates the lease agreement, established by the exclusive clause in the employment agreement. [See Form 111 §4.1a]

Also, fee provisions containing a safety clause allow the broker to collect a fee if property located by the broker and disclosed to the tenant during the retainer period is later leased by the tenant in negotiations commenced during the one-year period after the exclusive authorization expires. [See Form 111 §4.1c]

If the tenant decides not to lease space during the exclusive authorization period, the fee provision is structured so the broker can include payment of a consultation fee. A consultation fee is charged on an hourly basis for the time spent locating rental property. [See Form 111 §4.2]

An exclusive authorization to locate space is mutually beneficial to a prospective tenant and a broker. The employment commits the nonresidential tenant and broker to work together to accomplish a single objective — the leasing of space.

Understandably, an unrepresented tenant is at the mercy of the leasing agent employed by the landlord. An agent employed by a landlord owes the employing landlord an agency duty to use diligence in seeking the most qualified tenant and negotiating terms for a lease most favorable to the landlord.

Conversely, the landlord’s broker only owes a general duty to a non-client tenant. The general duty requires the leasing agent to disclose to the tenant all material facts about the property which might adversely affect its rental value.

The exclusive authorization to locate space is an employment agreement. It imposes on the broker an agency duty owed to the tenant, even though the fee will most likely be paid by the landlord.

The prospective tenant who exclusively authorizes a competent broker to locate space saves time and money. The licensed advisor conducts the search and handles negotiations to lease property on the prospective tenant’s behalf.

However, a tenant working directly with a landlord’s broker will initially (and properly) only be first shown space the broker has been employed by a landlord to lease.
In a rising market, when available space is scarce, landlords have superior negotiating power. Thus, it is in the tenant's best interest to employ a different broker from the landlord's broker as their exclusive representative.

Curiously, when a rising market allows landlords to control negotiations in real estate transactions and when prospective tenants most need representation, brokers tend to avoid entering into employment agreements with prospective tenants. It seems to be easier, during periods of rapidly rising prices and rents, to list property and lay back, waiting for the tenant to contact the landlord's broker, instead of the reverse activity of an agent locating property on behalf of a prospective tenant.

However, in a falling market, the opposite happens. Tenants have more negotiating power than landlords due to the increasing availability of space and properties. The result is that brokers have more trouble obtaining written employment agreements from prospective tenants than during periods of reduced availability of space.

Also, when the market position of landlords weakens, landlords eventually become more flexible in lease negotiations. During such markets, landlords are more apt to employ brokers to locate tenants and fill vacant space, particularly builders and developers.

Consider a nonresidential landlord who orally promises a broker to pay a fee if the broker locates a prospective tenant. A prospective tenant is located by the broker. The tenant is orally advised by the broker that the landlord has agreed to and will pay the broker's fee. No retainer agreements (listings) are entered into by the broker.

After seeing the property and before signing an offer to lease (with fee provisions), the tenant contacts the landlord directly to negotiate a lease. Ultimately, the tenant and landlord enter into a lease agreement. The documentation does not contain provisions for a broker's fee.

Here, the broker cannot enforce collection of their fee from the landlord since the landlord's promise to pay was oral.

However, the tenant has a different liability exposure. While the tenant did not promise to pay a fee, the broker makes a demand on the tenant for payment of an amount equal to the broker's fee promised by the landlord. The broker claims the tenant is liable since the tenant knew about the landlord's oral promise to pay the broker's fee, and interfered with that promise.

The tenant claims the broker is not entitled to recover the fee from them since a written fee agreement did not exist to evidence the fee agreement with the landlord.

Is the tenant liable for payment of the broker's fee?
Yes! The tenant is liable for the broker’s fee the landlord promised to pay since the tenant:

- was aware the landlord had promised to pay the broker a fee if the tenant leased the property; and
- excluded the broker from lease negotiations with the intent of avoiding payment of the fee.\(^3\)

When a tenant induces a landlord to deny the broker’s fee agreed to by the landlord, the tenant becomes liable for the fee. It does not matter whether the employment agreement between the broker and the landlord is oral or written.

The broker may not pursue the person who orally agreed to pay the fee. However, they may pursue a person who interferes with another person’s oral agreement to pay.\(^4\)

**Understanding dual agency**

Now consider a broker engaged to locate space on behalf of a prospective tenant. The broker fails to ask for and is not employed under an exclusive authorization to locate space. The broker extends the search to space other than the space they have listed for lease.

The broker locates space acceptable to the tenant. The landlord has not listed the space for lease with any broker.

To assure payment of a fee, the broker enters into a so called “one-time” or “one-party” listing agreement with the landlord.

The broker does not advise the landlord about the broker’s working relationship with the prospective tenant, which was an agency established by the broker’s prior efforts to locate suitable space on behalf of the tenant.

On receiving the “one-party” listing for the property, the broker presents the landlord with the tenant’s signed offer to lease or letter of intent (LOI). The landlord rejects the offer by making a counteroffer. Again, no disclosure or confirmation of the agency relationship with the tenant is made to the landlord.

Negotiations conducted by the broker between the tenant and the landlord ultimately result in an agreement to lease. The agreement also contains a provision stating the broker’s fee will be paid by the landlord.

Before the tenant takes possession and the broker is paid their fee, the landlord discovers the broker was also acting as an agent on behalf of the tenant. This dual agency relationship was not disclosed to the landlord when they were induced to employ the broker under the listing. The landlord delivers possession to the tenant, but refuses to pay the broker’s fee.

The broker makes a demand on the landlord for payment of the fee. The broker claims they acted as the exclusive agent of the tenant at all times. The

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\(^3\) Buckaloo v. Johnson (1975) 14 C3d 815


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**dual agency**
The agency relationship that arises when a broker represents both parties in a real estate transaction. [See ft Form 117]
In a rising market when available space is scarce, landlords have superior negotiating power. Thus, it is in the tenant’s best interest to employ a different broker from the landlord’s broker as their exclusive representative. In a falling market, tenants have more negotiating power than landlords due to the increasing availability of space and properties. The result is that brokers have more trouble obtaining written employment agreements from prospective tenants than during periods of short supply of space.

broker further claims they undertook no agency duty to act on behalf of the landlord in entering into the “one-party” listing to document collection of a fee from the landlord.

The landlord claims the broker is not entitled to a fee since the broker failed to disclose they were representing both parties as a dual agent prior to entering into the employment agreement.

Can the broker enforce collection of the fee?

No! The broker is not entitled to a fee. They were an undisclosed dual agent in the transaction.

The broker became the tenant’s agent when they undertook the task of locating and submitting all available suitable space to the tenant, particularly space not listed with the broker.

The broker also became employed as the landlord’s agent upon entering into the listing agreement with the landlord. The result was a conflicting employment. Upon entering into the employment with the landlord, the broker had a duty to disclose the resulting dual agency to both the landlord and tenant.5

Continuing the previous example, to avoid losing the right to collect a fee on the transaction, the proper practice for the broker is to negotiate with the tenant, not the landlord, to enter into a written employment agreement.

Also, an agency relationship with the landlord is unnecessary when the broker prepares and submits the tenant’s offer to lease to the landlord. The landlord may agree to pay the fee in an offer to lease or the lease agreement without ever becoming the employer of the broker as their agent. Thus, the issue of a dual agency does not arise.


Chapter 12 Summary

Need for a written employment agreement
An exclusive authorization to locate space entered into by a prospective tenant assures the broker a fee if the tenant ultimately leases space of the type and in the area noted in the authorization. An exclusive authorization to locate space is mutually beneficial to a prospective tenant and a broker since it commits a nonresidential tenant and broker to work together to accomplish a single objective — the leasing of space.

A leasing agent is to investigate and confirm why the tenant wants to move if they are to understand the tenant’s needs. When gathering information from a tenant, a diligent agent prepares a tenant lease worksheet to assess the tenant’s space requirements and the financial strength of the tenant’s business. By uncovering the precise reasons for moving, the agent is best able to find a suitably located space, or negotiate a renewal or extension of the tenant’s existing lease.
Cost of operating in leased space

After reading this chapter, you will be able to:

- use the property expense profile to disclose to prospective tenants the costs they will likely incur to use and maintain a property;
- understand the duties owed a tenant by the landlord’s leasing agent to disclose facts about the property that adversely affect the tenant’s use of the property;
- distinguish the additional duties owed a tenant by their agent to advise on the consequences of the property operating facts disclosed by the landlord’s agent; and
- apply property operating data to assist prospective tenants in the selection of suitable space.

Today, property operating data is readily available as property management services have become computerized. As a result, prospective tenants making decisions about leasing property have greater awareness and higher expectations when seeking a broker’s advice.
Yet, brokers have not delivered more information in response to tenant demand. Rather, tenants continue to suffer adverse results when renting for failure to receive property information known and undisclosed by the brokers and agents involved. [See Form 562 accompanying this chapter]

This failure has prompted the legislature to take action, expanding a broker’s duty to disclose known and knowable facts which might adversely affect a property’s value. Brokers are charged with knowing readily available facts affecting the rental pricing and utility of the property they are marketing.¹

Furthermore, when representing a prospective tenant, a broker and their agents need to take reasonable steps to care for and protect the client’s interest.²

Peer pressure among leasing agents to remain silent about conditions, such as local governmental use requirements for occupancy certificates, often keeps prospective tenants unaware of property-related issues that will adversely affect their use of the property.

A broker representing tenants bears a greater burden to investigate and advise their client about property conditions than does the landlord’s broker. Knowing the tenant’s needs and capacities is also essential to properly managing the broker-tenant agency relationship as well as the broker’s selection of suitable space.

Upon locating a qualifying property, the tenant’s broker needs to base their property disclosures on their own investigations, not conjecture before executing leases. Earlier property representations credited to another source and not known or believed to be false by the broker are acceptable to get negotiations underway. Eventually, when commitments are to be made by the tenant, the property information from others needs to be confirmed or corrected.³

As couriers of information and the “gatekeepers” for almost all real estate transactions, brokers are retained by consumers (prospective tenants and buyers) to inform them of relevant conditions surrounding a property. Brokers and their agents are the presumed experts, licensed and trained in the issues that affect pricing and users of property. Relevant information includes the costs of occupying and ongoing operations within a space, collectively called operating expenses.

As for a landlord and their leasing agent, their role in marketing space is limited to:

- disclosing facts about the property that adversely affect the value and use of the property; and
- avoiding misleading disclosures.

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¹ Jue v. Smiser (1994) 23 CA4th 312; Calif. Civil Code §2079
The duty the landlord’s broker owes tenants does not require them to advise tenants about any adverse consequences the disclosed facts might have on the tenant. Advice on the consequences of the facts disclosed is the duty owed to the tenant by the tenant’s broker.

The tenant needs to seek out this advice from an agent so they can make an informed decision when selecting among all available properties.

It is the role and burden of the tenant’s leasing agent to fully ascertain the consequences of a property’s essential facts, or see to it the tenant investigates, and make relevant recommendations to assist the tenant to meet their goals.

The factual information and assistance which a landlord’s broker can offer prospective tenants falls into one of three general categories for analysis:

1. *The property’s physical aspects*, including square footage, shipping facilities, utilities, HVAC units, tenant improvements, sprinkler system, condition of the structure, soil, geologic hazards, toxic or noise pollution, parking, etc.;

2. *The conditions of occupancy affecting the use and enjoyment of the property*, i.e., facts available on request from title companies (CC&Rs, trust deeds and vesting), planning departments (uses permitted), redevelopment agencies, business tax rates, police and fire department response times, security, natural hazards and conditions of the neighborhood surrounding the location; and

3. *The cost of operating the leased premises when put to the expected use.*

A property’s operating costs include business taxes local agencies charge a tenant for locating and conducting business in their jurisdiction. Taxes weigh on the selection of available space, as does access to highways and the client’s market. Business taxes vary greatly from city to city, as do police response time and criminal activity.

A property’s operating expenses are part of its signature, distinguishing it from other available properties. Data on a property’s operating costs are gathered and set forth on the *property expense profile* which is handed to prospective tenants. These profiles are used by leasing agents to induce tenants to rent their landlord-client’s space rather than other comparable space. [See Form 562]

Property-related expenditures incurred by a tenant of a specific property during the leasing period are classified as:

- **recurring operating expenses**;
- **nonrecurring deposits or charges** [See Chapter 14]; or
- rent and payments on loans secured by the tenant’s leasehold.
Tenants, their leasing agents, and property managers compare the costs a tenant will incur to occupy and operate in a particular space against the costs to operate in other available space, a type of comparative cost analysis. Tenant improvements are a type of acquisition cost that the tenant has to contend with (paid for up front or over the initial term of the lease), whether constructed by the landlord or the tenant.

The tenant’s comparative cost analysis is even more relevant to negotiations during periods of economic slowdown. Overbuilding or a decline in the number of nonresidential tenants increases vacancy levels. When this
The economic function of the marketplace will dictate a reduced rent rate until demand for space fills up the present supply of available space and rental rates rise.

When tenants search for space without the pressure of high occupancy levels and the attendant scarcity of space, they are more likely to compare properties. They are also more likely to select a property based on operating costs or the cost of tenant improvements (TIs), rather than rent alone.
Landlords leasing their properties for below-market rents need to be queried for information and history on the operating costs the tenant will incur in addition to the rent. Below-market rent raises suspicions of property obsolescence due to aging and loss of function, or excessive operating costs such as utility charges, local taxes, security needs, use requirements, neighborhood issues, crime, etc.

Without knowledge of property operating costs, the prospective tenant is left to speculate about the costs (other than rent) of leasing the property. For the tenant, this is a financially unsound starting place for negotiating a lease.

Nondisclosure of operating costs is more likely to occur during tight rental markets when inventories of leased space are tight. Increased competition between tenants for available space induces landlords and their brokers to be less cooperative in the release of adverse property information to tenants and their agents. This asymmetric condition provides the tenant with less information than the landlord and the landlord’s broker holds. These market conditions create a predatory environment which deprives the tenant of data influencing their choice to rent and ability to negotiate.

At a bare minimum, the tenant’s leasing agent has the obligation to bring known and readily available data to the tenant’s attention. The tenant may then obtain additional information during negotiations or by requiring the information from the landlord through a contingency provision before taking occupancy.

At their best, the tenant’s leasing agent not only advises, but also investigates and reports to their client on the data they collect. They provide analysis and recommendations to their tenant. Landlords’ leasing agents are generally unhappy about these inquiries, preferring reduced transparency and instant uninformed action.

The landlord either knows, or can easily obtain from their property manager or current tenant, the actual costs of operating their property for the intended use. Thus, property operating data is readily available to the landlord. If the landlord or the landlord’s broker refuses to supply the data to the tenant, the tenant’s broker can:

- investigate the expenses the current and prior tenants have experienced;
- make any offer to lease contingent on getting data; or
- use a letter of intent (LOI) to provide a method of getting information. [See Figure 1, Form 185]

Armed with knowledge of the costs, the tenant’s broker can comfortably disclose the operating expenses to their client.

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The duty of a tenant’s agent to investigate and advise

**property operating data**
The actual costs of operating a property for its intended use.

**letter of intent**
A non-binding proposal signed and submitted to a property owner to start negotiations.
Leases on nonresidential properties often include **common area maintenance charges (CAMs)**. CAMs are intended to be expenses incurred by the landlord and paid by the tenant as rent additional to the base rent, adjustments and percentages. However, the use of CAMs set as a percentage of the base rent are used to effectively increase rental income (and make the property’s published rental rate appear advantageous) without ever incurring or accounting to the tenant for amounts spent.

The prospective tenant and their agent need to insist on the seller providing an operating cost sheet itemizing the monthly CAMs the tenant will incur for their share of the common area maintenance.

Information about CAMs paid by the prior occupant of the space might affect the tenant’s negotiations and rental commitment. Thus, such information is a material fact essential to the tenant’s decision-making process. It’s all part of the rent payments to the landlord structured essentially as net leasing arrangements for multi-tenant properties, not single user property. [See first tuesday Form 552-3]

During a tight leasing market with reduced availability of space, landlords sometimes deceptively increase their net income by adding fixed amounts as CAMs instead of directly raising rents. Thus, they fractionalize the rent to distract the prospective tenant with what initially appears to be a competitive rent, until the extent of the CAMs are brought up well into negotiations.

The landlord’s broker has a duty to disclose the actual costs which have been incurred by tenants in the space. If hard numbers are not available, a landlord’s broker may provide estimates. However, estimates are required to be reasonably accurate, not the product of guesswork. Further, the landlord’s broker needs to state they are estimates when they are not data actually experienced.

Also, the landlord’s broker needs to identify the source of the data provided to the tenant and rate its reliability as known to the broker. If the data or source of the data is questioned, the offer to lease (or counter offer) needs to include a **further-approval contingency**. [See Figure 1, Form 185 §9]

The **further-approval contingency** provision allows the tenant time to investigate and confirm the property information disclosed by the landlord. If the information cannot be confirmed, or is contrary to the information disclosed, the tenant their agent may cancel or renegotiate the offer to lease.4

Best practices when disclosing operating costs include:

- the preparation of a **property expense profile** for each available unit, prepared by the landlord or property manager and signed by the landlord [See Form 562]; and
- a comparison by the tenant and the tenant’s broker of the economic cost of rent, and other operating expenses for one space versus operating costs and rent incurred in other qualifying spaces.

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4 **Ford v. Courmaine** (1973) 36 CA3d 172
With documentation and a comparative analysis of rent and operating costs complete, the tenant and the tenant’s broker can intelligently negotiate the best lease arrangements available for the tenant in the local market.

Occasionally, a landlord may want to be “tight-lipped” about the operating data due to various different arrangements with numerous tenants. In this case, the landlord may insist on (or be offered by the tenant) a confidentiality agreement before releasing any data to the prospective tenant.

Tenants who forego representation by an agent lose the benefit of a comparative analysis. They also incur risk since they will miss out on the experience and advice of a licensee retained to represent their best interests.

Chapter 13

Key Terms

A property’s operating costs are part of its signature, distinguishing it from other available properties. Data on a property’s operating costs are gathered and set forth on the property expense profile which is handed to prospective tenants. These profiles are used by leasing agents to induce tenants to rent their landlord-client’s space rather than other comparable space.

The duty the landlord’s broker owes tenants does not require them to advise tenants about any consequences the disclosed facts might have on the tenant. Advice on the consequences of the facts disclosed is the duty owed to the tenant by the tenant’s broker. Thus, it is the role and burden of the tenant’s leasing agent to fully ascertain a property’s essential facts and make relevant recommendations to assist the tenant to meet their goals.

Without knowledge of property operating costs, the prospective tenant is left to speculate about the costs (other than rent) of leasing the property. For the tenant, this is a financially unsound starting place for negotiating a lease. The tenant’s comparative cost analysis is even more relevant to negotiations during periods of economic slowdown.
Chapter 14: Security deposits and pre-expiration inspections

After reading this chapter, you will be able to:

- understand the use of a security deposit as a source of recovery for money losses incurred by the landlord due to a tenant default on obligations agreed to in a rental or lease agreement;
- notify a residential tenant of their right to request a joint pre-expiration inspection of their unit prior to vacating;
- apply the differing residential and nonresidential security deposit refund requirements; and
- provide an itemized statement of deductions to account for recoverable expenses and any interest accrued the landlord is to pay on the security deposit.

Both nonresidential and residential landlords prudently require a tenant to pay the first month’s rent and make a security deposit as a requisite to entering into a rental or lease agreement. [See first tuesday Form 550, 551 and 552]

The security deposit provides a source of recovery for money losses incurred due to a default on obligations agreed to in the rental or lease agreement. Tenant monetary obligations include:

- paying rent;

Learning Objectives

Key Terms

final inspection
itemized statement of deduction
joint pre-expiration inspection

rent
security deposit
statement of deficiencies

Cover for a tenant’s nonperformance
• reimbursing the landlord for expenses incurred due to the tenant’s conduct;
• maintaining the premises during occupancy; and
• returning the premises in the same level of cleanliness as existed at the time possession was initially taken, less ordinary wear and tear.

The amount of *security deposit* the residential landlord may demand and receive is controlled. Further, the amount of any security deposit is greatly influenced by the current condition of the local residential and nonresidential market. If competition is tight, a landlord may be forced to lower the security deposit amount required to attract tenants.

Aggressively competitive landlords are less likely to require a security deposit. However, this exposes them to an increased risk of loss if the tenant defaults, a foreseeable event.

Any monies handed to a residential landlord by a tenant on entering into a rental or lease agreement are characterized as one of the following:

- rent;
- a *security deposit*;
- a *waterbed administrative fee*; or
- a *tenant screening fee* for processing an application.¹ [See Chapter 15]

*Rent* is compensation, usually paid periodically, received by a landlord in exchange for the tenant’s use, possession and enjoyment of the property.²

*Editor’s note —* Rent by agreement also includes amounts due from a tenant in payment of late charges on delinquent rent, and bounced check charges.³

Residential tenants, unlike nonresidential tenants, lack sufficient bargaining power when negotiating a rental or lease agreement. To prevent residential tenants from abuse, California public policy and laws limit the amount of security deposits a residential landlord may demand and collect from a tenant.

Residential security deposits are limited to:

- two months’ rent for unfurnished units; and
- three months’ rent for furnished units.⁴

A residential landlord may also collect one month’s advance rent. This amount is not included in the security deposit limit.

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¹ Calif. Civil Code §§1940.5(g); 1950.5(b); 1950.6(b)
² Telegraph Ave. Corporation v. Raentsch (1928) 205 C 93
³ Canal-Randolph Anaheim, Inc. v. Wilkoski (1978) 78 CA3d 477
⁴ CC §1950.5(c)
For residential rental properties, all monies paid to the landlord in addition to the first month’s rent are considered part of the security deposit, except screening fees and waterbed administrative fees. [See Case in point, “To defer the first month’s rent”]

Landlords often try to “mask” refundable security deposit funds by giving them names such as “nonrefundable deposit”, “cleaning charge” or “last month’s rent.” However, any advance of funds in excess of the first month’s rent, screening fees and waterbed administrative fees, no matter how characterized by the residential landlord, are classified as security deposits, subject to the above limits. 5

A residential landlord has limited authority to also demand and collect a pet deposit as part of the maximum security deposit allowed if the tenant is permitted to keep one or more pets in the unit. However, the total advance funds, including the pet deposit, may still not exceed the above limits. 6

Any funds received and legally recharacterized as a security deposit are refundable when the tenant vacates, less permissible deductions.

The amount of a residential security deposit demanded of prospective tenants needs to be uniform based on either the amount of the rent charged or the tenant’s creditworthiness.

If the security deposit is based on a tenant’s creditworthiness, the landlord needs to establish clear and precise standards for the different levels of creditworthiness (such as credit scoring) they use in the selection of tenants. Further, the security deposit amount set for each level of creditworthiness is to be applied to every prospective tenant who falls within each level. 7

Further, a landlord cannot require higher security deposits for tenants with children than for tenants without children as this is a prohibited discriminatory act. Any increase in a security deposit for larger versus smaller families is also a prohibited discriminatory practice. 8 [See Chapter 36]

An additional security deposit may be demanded and collected when a tenant maintains a waterbed in an unfurnished rental unit. [See first tuesday Form 564]

This waterbed deposit cannot exceed an amount equal to one-half month’s rent. This waterbed deposit is in addition to the first month’s rent and the maximum permissible security deposit.

The landlord may also charge a reasonable fee to cover administrative costs of processing the waterbed arrangements. 9

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5 CC §§1940.5; 1950.5(b), (c); 1950.6
6 CC §1950.5(c)
7 24 Code of Federal Regulations §100.60(b)(4)
8 Calif. Government Code §12955(a); 24 CFR §100.65
9 CC §1940.5(g)
Consider a residential landlord who locates a creditworthy tenant. In addition to the advance payment of the first month’s rent, the landlord requires a security deposit equal to one month’s rent.

The tenant asks the landlord if they can pay half the security deposit in advance and the other half with the second month’s rent. The tenant is unable to pay the security deposit in full until they receive their security deposit refund from their current landlord.

The landlord wants this applicant as a tenant and is willing to extend the credit.

To be cautious, the landlord structures receipt of the tenant’s funds as payment of the entire security deposit and half of the first month’s rent. The tenant will pay the remaining half of the first month’s rent with payment of the second month’s rent.

Thus, if the tenant fails to pay the second month’s rent and the remainder of the first month’s rent when due, the landlord may serve the tenant with a three-day notice to pay rent or quit. Then, if the tenant vacates, the landlord may deduct all rents accrued and due from the security deposit. The reason: an unpaid portion of the security deposit cannot be collected by enforcement while unpaid rent can be collected by deduction from the security deposit.

Conversely, consider a landlord who allows a tenant to allocate their initial payment on the lease to one full month’s rent paid in advance, with payment of the balance due on the security deposit spread over two or more months.

Here, if the tenant fails to pay the promised installments of the security deposit, the default is not considered a material breach of the rental or lease agreement. A material breach is necessary before an unlawful detainer (UD) action based on service of a three-day notice to perform can proceed to an eviction. A security deposit is not rent, although it is an amount “owed” to the landlord.

The landlord is protected by classifying the initial advance payment as fully prepaying the security deposit. The security deposit then covers any default in the promise to pay deferred rent.

A tenant’s breach must be material and relate to the economics of the rental agreement or lease, such as a failure to pay rent, before the landlord can justify service of a three-day notice. However, while they are considered “rent”, a failure to pay late charges, returned check charges and deferred security deposit is considered a minor breach. Thus, failure to pay these amounts does not justify the serving of a three-day notice to quit.

Failure to deliver rent and other amounts regularly paid to the landlord, such as CAMs on nonresidential leases, is a material breach supporting forfeiture of the tenant’s leasehold and right of possession of the property. [Baypoint Mortgage v. Crest Premium Real Estate Investments Retirement Trust (1985) 168 CA3d 818]

A nonresidential landlord has the discretion to set security deposit amounts under a rental or lease agreement. Amounts set for nonresidential deposits are generally based on the tenant’s type of operations, the accompanying risks of damage they pose to the leased property and creditworthiness.

For instance, a small services firm may pay an amount equal to one month’s rent as a security deposit, to cover a default in rent. On the other hand, a photography studio which uses chemicals in its rendering of services may be asked to pay an amount equal to two or more month’s rent.
Editor’s note — A photography studio tenant, laundry facility or other users of chemicals must be required to provide insurance coverage for losses due to toxic conditions created on the property.

Like all other terms in a nonresidential lease agreement, the amount of the security deposit is negotiable between the nonresidential landlord and the tenant prior to entering into the lease.

When the availability of unfurnished residential units is tight, residential landlords often require all prospective tenants to advance the maximum permissible amount of rent and security deposit. Landlords charge maximum amounts upfront in hopes of preventing less solvent tenants from renting their units.

For residential rentals, the first and last month’s rent are legally recharacterized as the first month’s rent and a security deposit equal to one month’s rent.¹⁰

Nonresidential landlords typically require an advance payment of both the first and last month’s rent on a lease. They do so without considering that an advance payment of the last month’s rent is economically equivalent to a security deposit, as is mandated by residential rental rules.

Now consider a residential tenant who pays the first month’s rent and a security deposit equal to one month’s rent.

When the last month’s rent becomes due, the tenant does not pay it. The tenant knows the defaulted payment of rent will be deducted from his security deposit. This is a permissible use of the security deposit by the landlord. The landlord does not attempt to have the tenant evicted since the tenant will vacate before an eviction under an unlawful detainer (UD) action is processed.

On expiration of the lease, the tenant vacates the unit. Due to excess wear and tear on the unit inflicted by the tenant, repairs and replacements are required before the unit can be re-rented.

However, after deducting the unpaid last month’s rent from the security deposit, no money remains to reimburse the landlord for the cost of the repairs.

The recovery of the repair costs is initiated by a demand on the tenant for payment. If unpaid, a small claims court action may be used to enforce collection.

If the landlord requires advance payment on the first and last month’s rent but no security deposit, a similar demand is made on the tenant for payment of repair costs.

¹⁰ CC §1950.5(c)
Security deposits are held by the landlord as impounds. The funds belong to the tenant who advanced them and are to be accounted for by the landlord.11

However, while the security deposit belongs to the tenant, a landlord may commingle the funds with other monies in a general business account. No trust relationship is established when a landlord holds a tenant’s security deposit.12

11 CC §§1950.5(d); 1950.7(b)
Without a trust relationship, the landlord’s receipt of a security deposit does not obligate them to pay interest on the security deposit for the period held. However, some local rent control ordinances require residential landlords to pay interest at or below bank savings account rates to tenants on their security deposits.

A residential landlord is to notify a tenant in writing of the tenant’s right to request a joint pre-expiration inspection of their unit prior to the tenant vacating the unit.

**Editor’s note** — The notice of right to request a joint pre-expiration inspection must also contain a statement notifying residential tenants of their right to reclaim abandoned personal property. [See Chapter 24; see Form 567-1 §5 accompanying this chapter]

However, unless the tenant requests an inspection after receiving the notice, the landlord and their agents are not required to conduct an inspection or prepare and give the tenant a statement of deficiencies before the tenancy expires and the tenant vacates.

The notice requirement does not apply to tenants who unlawfully remain in possession after the expiration of a three-day notice to pay/perform or quit.

The purpose for the joint pre-expiration inspection, also called an initial inspection, is to require residential landlords to advise tenants of the repairs or conditions the tenant needs to perform or maintain to avoid deductions from the security deposit.
When a residential tenant requests the pre-expiration inspection in response to the notice, the joint pre-expiration inspection is to be completed no earlier than two weeks before the expiration date of:

- the lease term; or
- a 30-day notice to vacate initiated by either the landlord or the tenant.¹³

[See Form 567-1]

¹³ CC §1950.5(f)(1)
Ideally, the notice advising the tenant of their right to a joint pre-expiration inspection is given to the tenant at least 30 days prior to the end of the lease term. In the case of a rental agreement, the notice is provided immediately upon receiving or serving a 30-day notice to vacate.

A period of 30 days allows the tenant time to request and prepare for the inspection. After the inspection, the tenant has time to remedy any repairs or uncleanliness the landlord observes during the inspection. Thus, the tenant is provided time to avoid a security deposit deduction.

When the landlord receives the tenant’s oral or written request for a pre-expiration inspection, the landlord serves a written 48-hour notice of entry on the tenant stating:

- the purpose of entry as the pre-expiration inspection; and
- the date and time of the entry.

If the landlord and tenant cannot agree to the date and time of the inspection, the landlord may set the time. However, if a mutually acceptable time for the inspection is within 48 hours, a written waiver of the notice of entry is to be signed by both the landlord and tenant.
When the waiver is signed, the landlord may proceed with the inspection.\textsuperscript{14} [See \textit{first tuesday} Form 567-2]

Following service on the tenant of the 48-hour notice, the landlord may inspect the property whether or not the tenant is present, unless the tenant has previously withdrawn their request for the inspection.

\textsuperscript{14} CC §1950.5(f)(1)
On completion of the joint pre-expiration inspection, the landlord gives the tenant an itemized **statement of deficiencies**. In it, the landlord specifies any repairs or cleaning which need to be completed by the tenant to avoid deductions from the security deposit.

Also, the itemized **statement of deficiencies** is to contain the contents of subdivisions (b) and (d) of Calif. Civil Code §1950.5. [See Form 567-3 accompanying this chapter]

The landlord’s pre-expiration inspection statement is prepared at the time of the inspection and delivered to the tenant by either:

- handing the statement directly to the tenant if they are present at the inspection; or
- leaving the statement inside the premises at the time of the inspection if the tenant is not present.\(^{15}\)

If the tenant chooses to withdraw their request for an inspection after submitting it, the landlord needs to send a memo to the tenant confirming the tenant’s decision to withdraw. [See **first tuesday** Form 525]

**Editor’s note — The completion of a pre-expiration inspection statement by the landlord does not bar the landlord from deducting other costs from the security deposit for:**

- any damages noted in the joint pre-expiration inspection statement which are not cured;
- any damages which occurred between the pre-expiration inspection and termination of the tenancy; or
- any damages not identified during the pre-expiration inspection due to the tenant’s possessions being in the way.\(^{16}\)

Within a window period of 21 days after a residential tenant vacates, the residential landlord is to:

- complete a **final inspection** of the premises;
- refund the security deposit, less reasonable deductions; and
- provide the tenant with an **itemized statement of deductions** taken from the security deposit.\(^{17}\) [See Form 585 accompanying this chapter]

Also, the residential landlord is to attach copies of receipts, invoices and/or bills to the itemized statement showing charges incurred by the landlord that were deducted from the security deposit.\(^{18}\)

If repairs by the landlord are not completed and the costs are unknown within 21 days after the tenant vacates, the landlord may deduct a good faith estimated amount of the cost of repairs from the tenant’s security deposit.

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\(^{15}\) CC §1950.5(f)(2)  
\(^{16}\) CC §1950.5(f)  
\(^{17}\) CC §1950.5(g)  
\(^{18}\) CC §1950.5(g)(2)
This estimate is stated on the itemized security deposit refund statement. This statement is to disclose the name, address and telephone number of any person or entity providing repair work, materials or supplies for the incomplete repairs.\(^{19}\)

Then, within 14 days after completion of repairs or final receipt of bills, invoices or receipts for the repairs and materials, the landlord is to deliver to the tenant a final itemized security deposit refund statement with attached receipts and invoices.\(^{20}\)

It is not necessary for the landlord to provide copies of receipts, bills or invoices for repair work or cleaning to the tenant if:

- the total deduction from the security deposit to cover the costs of repairs and cleaning is equal to or less than $125; or
- the tenant signs a waiver of their right to receive bills when or after notice to terminate their tenancy is given.\(^{21}\)

If the residential landlord is not required to provide copies of receipts to the tenant, the tenant may still request copies of receipts for repair work or cleaning within 14 days after receipt of the itemized security deposit refund statement. The landlord is then to provide copies of the documents within 14 days after receipt of the tenant’s request.\(^{22}\)

*Editor’s note — Residential security deposits may be refunded to the tenant electronically by mutual agreement between the landlord and the tenant. The itemized statement of deductions from the security deposit, with copies of receipts, may be delivered via email.*\(^{23}\)

Reasonable deductions from a residential tenant’s security deposit include:

- any unpaid rent, including late charges and bounced check charges incurred and requested on a proper demand;
- recoverable costs incurred by the landlord for the repair of damages caused by the tenant;
- cleaning costs to return the premises to the level of cleanliness as existed when initially leased to the tenant, less wear and tear; and
- costs to replace or restore furnishings provided by the landlord if agreed to in the lease.\(^{24}\)

The landlord may not deduct from a tenant’s security deposit the costs they incur to repair defects in the premises which existed prior to the tenant’s occupancy. To best avoid claims of pre-existing defects, a joint inspection of the unit and written documentation of any defects is completed before possession is given to the tenant. [See Form 560 in Chapter 26] \(^{25}\)

\(^{19}\) CC §1950.5(g)(3)
\(^{20}\) CC §1950(g)(3)
\(^{21}\) CC §1950.5(g)(4)
\(^{22}\) CC §1950.5(g)(5)
\(^{23}\) CC §1950.5
\(^{24}\) CC §§1950.5(b); 1950.7(c)
\(^{25}\) CC §1950.5(e)
As previously discussed, when a residential tenant vacates, the landlord provides the tenant with a security deposit refund accounting. If local rent control ordinances (or state law) require the landlord to pay interest on security deposits, the landlord uses the *itemized statement of deductions* to account for interest accrued on the security deposit. [See Form 585 §4.3](#)

A residential landlord who, in bad faith, fails to comply with security deposit refund requirements is subject to statutory penalties of up to twice the amount of the security deposit. Additionally, the landlord is liable to the tenant for actual money losses the tenant incurs for the wrongful retention of security deposits.26

As an aside, on the landlord’s sale of a residential or nonresidential property, the landlord is to deliver an itemized statement to tenants stating:

- the amount of the tenant’s security deposit;
- any deductions made from the security deposit; and
- the name, address and telephone number of the buyer.

The notice, important for the seller, shifts liability to the buyer of the property for the future return of the security deposit to the tenant.27 [See first tuesday Form 586](#)

A nonresidential lease does not need to set forth:

- the circumstance under which a tenant’s security deposit will be refunded; or
- a time period within which a landlord will refund a tenant’s security deposit. [See first tuesday Form 552 through 552-4](#)

However, a nonresidential landlord is to refund the security deposit within 30 days after the transfer of possession of the property from the tenant to the landlord if:

- a refund period is not agreed to; and
- the nonresidential landlord takes no deductions from the security deposit.

Permissible deductions from the security deposit include unpaid rent, cost of cleaning or repairs.

Occasionally, the security deposit exceeds two months’ rent and the only deduction from the deposit is for delinquent rent. Here, the nonresidential landlord is to return any remaining amount in excess of one month’s rent within two weeks after the transfer of possession of the property to the landlord. The remaining amount of the security deposit is to be returned to the tenant or accounted for within 30 days after the transfer of possession.28

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26 CC §1950.5(l)
27 CC §§1950.5(h); 1950.7(d)
28 CC §1950.7(c)
Unless otherwise stated in the rental or lease agreement, the nonresidential landlord is prohibited from deducting additional costs from the security deposit for “key money” or to cover attorney’s fees incurred in preparing, altering or renewing the lease or rental agreement.29

Unlike the residential landlord, the nonresidential landlord is not required to provide tenants with an itemized statement of deductions when the security deposit is refunded. However, a prudent nonresidential landlord provides tenants with an itemized statement when they vacate, unless a full refund is made.

An accounting avoids the inevitable demand for documentation which arises when a tenant does not receive a full refund of their security deposit. A nonresidential landlord who, in bad faith, fails to comply with the refund requirements is liable to the tenant for up to $200 in penalties.30

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29 CC §1950.8(b)
30 CC §1950.7(f)

Chapter 14
Summary

The security deposit provides a source of recovery for money losses incurred due to a tenant’s default on obligations agreed to in the rental or lease agreement.

The amount of security deposit the residential landlord may demand and receive is controlled by codes. On a nonresidential landlord’s entry into a rental and lease agreement, security deposit amounts may vary at the landlord’s discretion.

A residential landlord is to notify a tenant in writing of the tenant’s right to request a joint pre-expiration inspection of their unit prior to the tenant vacating the unit. The joint pre-expiration rules require residential landlords to advise tenants of the repairs or conditions the tenant needs to perform or maintain to avoid deductions from the security deposit.

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Chapter 14
Key Terms

- final inspection ................................................................. pg. 151
- itemized statement of deductions ................................. pg. 153
- joint pre-expiration inspection .............................. pg. 147
- rent ................................................................. pg. 142
- security deposit .................................................. pg. 141
- statement of deficiencies ........................................ pg. 151
Residential turnover cost recovery

After reading this chapter, you will be able to:

- analyze the landlord’s recovery of residential tenant turnover costs;
- classify funds received from a tenant by a residential landlord as either rent, security deposits, waterbed administrative fees or tenant screening fees;
- avoid liquidated damages and stay-or-pay provisions as unenforceable; and
- mitigate expenses that reduce the landlord’s net operating income (NOI) due to tenant turnover.

**Key Terms**

- liquidated damages provision
- “stay-or-pay” clause
- net operating income

Following a cost-reduction review of management operations, the landlord of an apartment complex is determined to offset the recent increase in the cost of tenant turnover by shifting the costs to tenants.

Each tenant turnover requires expenditures to:

- refurbish the unit to eliminate the cumulative effect of normal wear and tear brought about by the tenant’s use of the unit;
- advertise the unit’s availability to locate a tenant; and
- pay leasing fees to the property manager.

An increasing number of the landlord’s tenants are staying for shorter periods of time. On vacating, the units are re-renting quickly. Thus, lost rent due to turnover is kept to a minimum. However, the landlord cannot raise rents to cover the increasing annual costs without losing tenants to competing units.
At issue is the landlord’s net operating income (NOI). It is being reduced by the increased frequency of refurbishing and reletting costs. [See Figure 3, Form 352]

Worse, any reduction in the NOI due to the increasing turnover costs becomes an equivalent dollar reduction in the landlord’s spendable income remaining after payment on mortgage financing.

From an accounting point of view, the NOI is calculated by subtracting operating costs from rental income generated by the property.

Also, the landlord is concerned about the economic impact of the decreased NOI on the property’s value. The NOI is the basis for establishing the property’s market value and maximum mortgage amount.

To maintain or increase the property’s NOI and net spendable income (and the property’s value), the landlord chooses to add a “stay-or-pay” clause addendum to the month-to-month rental agreements.

The stay-or-pay clause states the residential tenant foregoes a return of their security deposit if they move within six months after taking occupancy.

The landlord believes the stay-or-pay clause will dissuade month-to-month tenants from moving for at least six months.

If a tenant is not persuaded and vacates the premises within the first six months, the stay-or-pay clause provides for the landlord to recover “prematurely incurred” turnover costs by retaining the tenant’s security deposit.

Can the residential landlord enforce a stay-or-pay clause in rental agreements?

No! The stay-or-pay clause is an unenforceable penalty. It is an illegal forfeiture of the tenant’s security deposit. [See Figure 1]

Editor’s note — first tuesday rental and lease agreements do not include a stay-or-pay provision.

The security deposit is to be fully refunded, regardless of how long the unit remains vacant, if:

- the tenant has not breached the rental or lease agreement; and
- on expiration of proper notice, the tenant has fully paid all rents accrued and returns the unit in the condition it was received, less ordinary wear and tear.
The security deposit may not be used to cover either:

- rent lost due to the vacancy following expiration of a notice to vacate; or
- operating costs incurred to eliminate normal wear and tear and refurbish the unit for the next tenant.¹

Thus, the landlord cannot use a stay-or-pay clause in tandem with a security deposit to provide more revenue to cover operating costs. Revenue for operating expenses comes exclusively from rents, a cost-plus pricing imperative, and not from a one-time lump sum advance payment of any sort.

In review, funds received from a tenant by a residential landlord fall into one of only four classifications of receipts:

- rent;
- security deposits;
- a waterbed administrative fee [See Chapter 14]; or
- a tenant screening fee for processing an application.²

The amount of the tenant screening fee is capped.

Editor’s note — The maximum tenant screening fee can be found on the California Department of Consumer Affairs website, http://www.dca.ca.gov.

Further, the tenant screening fee is limited to:

- the out-of-pocket cost for gathering the information; and
- the cost of the landlord’s or property manager’s time spent obtaining the information and processing an application to rent.³

It is common practice for landlords and property managers to request a tenant to provide them with a copy of the tenant’s credit report. A tenant can obtain their credit report online from landlord-tenant screening services for far less than the maximum screening fee, or even free from the major credit reporting agencies.

In the opening scenario, the landlord is shown to fund the care and maintenance of a property from rents rather than an up-front lump sum amount paid by each tenant in addition to rent and a security deposit.

Now consider a residential landlord who requires new tenants to prepay the first month’s rent and a refundable security deposit in an amount equal to one month’s rent before entering into a rental or lease agreement.

¹ Calif. Civil Code §1950.5(e)
² CC §§1940.5(g); 1950.5(b); 1950.6(b)
³ CC §1950.6(b)
The landlord also charges an additional one-time, nonrefundable, new-tenant fee, key fee, membership fee, tenant application expense fee or other named garbage fee.

The stated purpose of the nonrefundable fee is to cover administrative expenses and services related to processing the tenant’s application to rent the unit, a sort of “key payment.”

On vacating the unit, the tenant makes a demand on the landlord to return the one-time extra charge. The tenant claims it is a security deposit since the one-time, lump-sum charge covers expenses which are properly paid from rents. This makes the application fee a masked security deposit.

Can the tenant recover the one-time extra charge imposed by the landlord?

Yes, but not as a security deposit! The one-time charge for administrative costs incurred by the landlord to process the tenant’s rental application is not a security deposit. A security deposit is imposed and collected to cover the landlord’s losses due to future tenant defaults on a rental or lease agreement.45

However, this “nonrefundable upfront fee” is an administrative fee controlled by the tenant screening fee statute.

Any overage paid by the tenant above the set limit is refundable as an excess screening fee charge which is neither rent nor a security deposit.

Consider a residential landlord who includes a liquidated damages provision in month-to-month rental agreements in an effort to offset tenant turnover costs. This provisions calls for a penalty payment equal to one month’s rent to be taken from the security deposit if the tenant returns possession before six months of occupancy.

In addition to the first month’s rent, the landlord properly collects a security deposit from the tenant in an amount equal to one month’s rent to cover any future breach of the rental agreement by the tenant.

Before six months passes, the tenant hands the landlord a 30-day notice to vacate, then vacates the unit.

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5 CC §§1950.5, 1950.6
Within 21 days after vacating, the landlord sends the tenant an itemized accounting for the security deposit. One of the itemized deductions is one month’s rent as the liquidated damages owed the landlord due to the early termination of the month-to-month rental agreement.

The tenant makes a demand on the landlord to refund the amount withheld from the security deposit for early termination of the rental agreement. The tenant claims a **liquidated damages provision** in a rental or lease agreement is unenforceable as it calls for payment of a forfeiture.

Is the liquidated damages provision in a rental or lease agreement enforceable?

No! A **liquidated damages provision** is unenforceable in rental and lease agreements, as it is in most other real estate transactions. Collectible damages are limited to out-of-pocket money losses.\(^6\) [See Figure 2]

*Editor's note — A liquidated damages provision creates wrongful expectations of windfall profits and are nearly always forfeitures and unenforceable. *first tuesday* forms do not include liquidated damages provisions.*

A liquidated damages provision may only be enforced in limited circumstances when accounting conditions make it extremely difficult or impracticable to determine the amount of actual money losses incurred by the landlord. This is never the case with real estate rentals as both the costs and time involved managing the costs are known.\(^7\)

The amount of recoverable losses a residential landlord incurs when a tenant vacates a unit, such as the lost rent and the maintenance costs of labor and materials to cover excess wear and tear, is readily ascertainable.

Further, liquidated damages do not represent a recovery of actual money losses incurred by the landlord. The purpose of the landlord’s liquidated damages provisions is not to recover money lost due to unpaid rent or excessive wear and tear, but to increase NOI and spendable income by a windfall.

Even if the landlord does not deduct the liquidated damages amount from the security deposit, they will not be able to recover the liquidated damages from the tenant in a civil action on the rental or lease agreement.

Recovery of a landlord’s turnover costs comes from the rents paid by tenants. Refurbishing costs are an expense of operations deducted from rental income.

The costs of refurbishing a unit to eliminate normal wear and tear so it can be re-rented in a “fresh” condition are known, or readily available on inquiry, in advance. Thus, they are not properly the subject of liquidated damages provisions.

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\(^6\) [CC \$1671(d)]

\(^7\) [CC \$1671(d)]
Financially, the amount of the refurbishing costs is best viewed as amortized over the length of each tenant’s period of probable occupancy. The costs will then be properly recovered as a component factored into the periodic rent charged to a tenant.

However, the local rental marketplace determines rent ceilings, not landlords. The market limits the amount a landlord can charge for rent and successfully compete for tenants.

Thus, a landlord’s most logical cost recovery approach is to negotiate with prospective tenants to stretch out their terms of occupancy to an optimal minimum number of months. The longer the average occupancy, the less frequent the tenant turnovers, and the greater the net spendable income.

While the market limits the rent a landlord can charge, different rent rates exist for month-to-month rental agreements and fixed-term lease agreements.

The landlord’s best method for recovering turnover costs is to rent to creditworthy tenants on a lease agreement with a one-year term or longer. Here again, the local rental market sets the maximum rent amount for this term. Economic conditions may even make six- or nine-month fixed-term leases feasible objectives.

A fixed-term occupancy allows the landlord to amortize the anticipated cost of refurbishing the unit over the term negotiated. Tenants under a lease agreement tend to remain in possession until the lease term expires. Thus, fixed-term arrangements reduce the frequency of move-outs and provide a schedule for turnover maintenance — the same objective sought by exploiting a forfeiture penalty period.

As a result, a landlord usually charges less rent on a lease agreement than under a month-to-month rental agreement. This lower rent is a reflection of lower overall refurbishing expenses, reduced annual vacancy rates, less management time and effort, and less risk of lost rents. Additionally, the lower rent may result in longer periods of occupancy and stave off the inevitable turnover.

As compensation, a landlord is able to charge higher rents for month-to-month tenancies. This higher rent reflects the cost-push of higher and more frequent turnover expenses per unit than occur under a lease.

A rental or lease agreement can be structured with tiered rents for future periods of continued occupancy. Tiered rents provide for a slightly higher rent for initial months included in the first-tier period — such as the first six months of the periodic tenancy — with lower rent amounts set for the following months if the tenant remains in possession.

If the month-to-month tenant continues in occupancy after the first-tier period, the rental agreement calls for a lower rent during a second-tier
period or for the remainder of the occupancy. This encourages tenants to stay longer since their rent will be lower. Both rental rates are consistent with the marketplace.

As a result, the landlord’s turnover costs are better amortized, “reserved” from the higher periodic rent charged during the period of the first tier.

However, tiered rents will only avoid the security deposit limitations if:

- the security deposit is a customary amount for the credit risk posed by the tenant;
• the higher monthly rent is consistently charged over a long enough period, say six months, to avoid recharacterization as a disguised or delayed receipt of a security deposit, tenant screening fee or forfeiture; and
• the tenancy is month-to-month.

The same economics and amortization logic applies to the cost of tenant improvements made by a nonresidential landlord (or a tenant).

For example, tenant improvements are recovered by a nonresidential landlord over the initial years of a lease as part of the rent amount. Rent for an extension (the second tier) is reduced to an amount which reflects the elimination of the improvement charges. This reduction is used to induce the tenant to stay for a greater period of time. The tenant improvements are paid for and now all the landlord needs to collect is rent for the value of the premises, less the paid-for tenant improvements.

Chapter 15
Summary

Each tenant turnover reduces the landlord’s net operating income (NOI) due to the increased frequency of refurbishing expenses and lost rents on vacancies. Recovery of a landlord’s turnover costs comes from the rents paid by tenants. Refurbishing costs are an expense of operations deducted from rental income.

The security deposit may not be used to cover either:
• rent lost due to the vacancy on expiration after notice to vacate; or
• operating costs incurred to eliminate normal wear and tear and refurbish the unit for the next tenant.

Financially, the amount of the refurbishing costs is best viewed as amortized over the length of each tenant’s period of probable occupancy. The costs are then properly recovered as a component factored into the periodic rent charged a tenant.

Liquidated damages and stay-or-pay provisions are unenforceable.

However, the local rental marketplace limits the amount a landlord can charge for rent and successfully compete for tenants. Thus, a landlord’s best recovery approach is to negotiate with prospective tenants to stretch out their terms of occupancy to an optimal minimum number of months.

Chapter 15
Key Terms

liquidated damages provision ................................................ pg. 159
net operating income ................................................................. pg. 156
“stay-or-pay” clause ................................................................. pg. 156
After reading this chapter, you’ll be able to:

• apply in practice the landlord’s right to receive partial rent under a partial payment agreement with a tenant;
• distinguish the rights of residential tenants from nonresidential tenants when paying partial rent; and
• determine when a landlord has the right to file an unlawful detainer (UD) action after receipt of partial rent.

nonwaiver of rights provision reservation of rights clause
partial payment agreement

A nonresidential tenant, also called a commercial or industrial tenant, experiences cash flow difficulties due to a business downturn. As a result, the tenant becomes delinquent in the payment of rent.

Discussions between the landlord and tenant follow. To enforce collection of the rent, the landlord eventually serves the tenant with a three-day notice to pay rent or quit the premises. [See Form 575 in Chapter 20]

Prior to the filing of an unlawful detainer (UD) action, the tenant offers to make a partial payment of the delinquent rent, if the landlord will accept it. Further, the nonresidential tenant offers to pay the balance of the delinquent rent by a specific date if the landlord agrees not to file a UD action called a partial payment agreement. [See Form 558 accompanying this chapter]

The partial payment agreement states:

• the amount received as partial rent;
• the amount of deferred rent remaining unpaid;
• a promise to pay the deferred rent;
• the date the payment is due; and
• the consequences of nonpayment.

If the deferred rent is not paid as scheduled, the nonresidential landlord may file a UD action to evict the tenant without serving another three-day notice. [See Form 558 §7]

Here, the partial payment agreement only temporarily delays the nonresidential landlord’s eviction process which commenced with the previous service of a three-day notice on the tenant.

The tenant fails to pay the deferred balance of the delinquent rent on the date scheduled for payment. Without further notice to the tenant, the landlord files a UD action.

The nonresidential tenant seeks to prevent the landlord from proceeding with the UD action. The tenant claims the landlord’s acceptance of the partial rent payment invalidated the prior three-day notice since the notice now states an amount of rent which is no longer due.

Can the nonresidential landlord accept a payment of partial rent after serving a three-day notice and later file a UD action against the tenant without serving another three-day notice for the amount remaining due and now delinquent?

Yes! A nonresidential landlord can accept a partial payment of rent after serving a three-day notice and before eviction. Without further notice to the tenant, the landlord can proceed with a UD action and evict the tenant.1

Continuing our previous example, on accepting a partial payment of delinquent rent, a nonresidential landlord does not need to agree to a new due date for the remaining rent. They also do not need to enter into any agreement regarding acceptance of the partial payment. However, the nonresidential tenant needs to be on notice that acceptance of late rent does not waive the landlord’s right to enforce remedies for any remaining breach of the lease agreement by the tenant. [See ft Form 552 §20 and 558 §7]

The impact of serving a three-day notice, then later accepting partial rent from a nonresidential tenant is vastly different from the protection a residential tenant is provided in partial rent situations.

1 Calif. Code of Civil Procedure §1161.1(b)
### PARTIAL PAYMENT AGREEMENT

**Nonresidential**

**Prepared by:**
- Agent: ____________________
- Broker: ____________________
- Phone: ____________________
- Email: ____________________

**DATE:** ____________________, 20______, at _____________________, California.

**FACTS:**
1. This partial payment agreement pertains to the collection of past due rent under a nonresidential rental or lease agreement:
   - **1.1** dated ____________________, at _____________________, California,
   - **1.2** entered into by ____________________, as the Tenant, and
   - **1.3** ____________________, as the Landlord,
   - **1.4** regarding leased premises referred to as ____________________.

**AGREEMENT:**
2. Tenant has not paid delinquent rent for the period(s) of ____________________.
3. Landlord hereby accepts partial payment on delinquent rent in the amount of ____________________.
4. The balance of the delinquent rent owed is ____________________.
   - **4.1** Plus late charges for delinquency(ies) of ____________________.
   - **4.2** Plus deferred rent processing charges of ____________________.
   - **4.3** Total deferred rent due, including additional charges, is the sum of ____________________.
5. Tenant to pay the total deferred rent on or before ____________________, 20______.
   - **5.1** Rent to be paid by ____________________, or ____________________, made payable to Landlord.
   - **5.2** Rent may be tendered by ____________________, or ____________________, to ____________________, at ____________________, (Name)
   - **5.3** Rent may also be paid by deposit into account number ____________________, at ____________________, (Financial Institution)
   - **5.4** No grace period for payment of the deferred rent is granted to Tenant.
   - **5.5** Delinquent payment of the deferred rent incurs a late charge of ____________________.
6. If deferred rent is paid when due, any outstanding three-day notice to pay rent or quit is no longer valid.
7. If the deferred rent is not paid when due, Landlord reserves the right to:
   - **7.1** Serve Tenant with a three-day notice to pay the remaining balance of the rent due or quit the premises.
   - **7.2** Commence, without further notice, an unlawful detainer action to evict Tenant from the premises.
   - **7.3** Continue with the unlawful detainer action on file to evict Tenant from the premises.
8. No provision of the rental or lease agreement is affected in this agreement.

**I agree to the terms stated above.**
- Check one box only
- **8.1** Serve Tenant with a three-day notice to pay the remaining balance of the rent due or quit the premises.
- **8.2** Commence, without further notice, an unlawful detainer action to evict Tenant from the premises.
- **8.3** Continue with the unlawful detainer action on file to evict Tenant from the premises.
- **8.4** No provision of the rental or lease agreement is affected in this agreement.

**Date:** ____________________, 20______

**Landlord:** ____________________
- **DRE #:** ____________________
- **Agent:** ____________________
- **Phone:** ____________________
- **Email:** ____________________

**Tenant:** ____________________
- **Signature:** ____________________
- **Phone:** ____________________
- **Cell:** ____________________
- **Email:** ____________________

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A residential landlord who accepts any amount of rent from a tenant after serving a three-day notice waives their right to use that notice as the basis for a UD action. After receiving partial rent, a residential landlord needs to serve the tenant with another three-day notice for the amount now remaining unpaid.²

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Acceptance of a partial payment toward delinquent rent is within the
discretion of the landlord. A landlord might agree to accept partial payments
when:

- the partial payment is at least equal to the rent accrued at the time the
tenant offers the payment;
- the tenant is creditworthy;
- the tenant has an adequate payment history; and
- the tenant is one the landlord wants to retain.

Both residential and nonresidential landlords may accept a partial payment of
delinquent rent. Then, unless they have agreed to the contrary, immediately
serve the tenant with a three-day notice demanding payment of the balance
due or quit. Of course, a landlord may agree in a partial payment agreement
not to serve a three-day notice after receipt of the partial payment of rent on
the condition the balance is received on or before a specified date. [See Form
558 and 559 accompanying this chapter]

If a residential landlord files a UD action and, prior to eviction, accepts a
partial payment of rent, the acceptance of rent nullifies the UD action and
the landlord may not proceed to eviction. The reason the UD action cannot
proceed lies in the difference between:

- the amount of rent demanded in the notice to pay supporting the UD
  action; and
- the amount actually remaining unpaid at the time of the UD hearing.

In residential UD actions, the amounts in the three-day notice and the
amount owed by the tenant are required to be the same. Once the residential
landlord accepts a partial payment of delinquent rent, the three-day notice
served on the tenant no longer states the correct amount the tenant is
pay to avoid losing the right of possession. This rule does not apply to
nonresidential tenancies.

Also, any three-day notice served on a residential tenant which overstates
the amount of delinquent rent due at the time of trial on the UD action is
invalid. The UD action in a residential eviction based on an overstated
amount in the three-day notice fails.3

Consider a nonresidential landlord who serves their tenant with a three-day
notice to pay rent or quit. Later, the landlord accepts a partial payment of rent
under an agreement with the tenant containing a nonwaiver of rights
 provision. This provision states the acceptance of rent does not waive the
landlord’s right to enforce a breach of the lease. If the nonwaiver notice is not
given, the nonresidential landlord needs to serve the tenant with another
three-day notice for payment of the sums remaining due and unpaid.

An alternative scenario exists since a nonwaiver of rights provision also exists in the nonresidential lease agreement entered into by the tenant. As a result, the tenant has received a nonwaiver of rights notice before the landlord’s acceptance of partial rent. Here, the landlord may take the money and file or continue with an already filed UD action to recover possession of the premises.4 [See first tuesday Form 552 §20]

For example, a nonresidential tenant defaults on a rent payment called for in their lease agreement which contains a nonwaiver of rights provision. The tenant is served with a three-day notice to pay or quit. The tenant fails to pay the rent before it expires, causing the tenancy to be terminated. The three-day notice to pay does not contain a provision for nonwaiver of rights on acceptance of partial rent.

The landlord then accepts a partial payment of rent without entering into any agreements, except to acknowledge receipt of the amount paid as rent. The nonresidential landlord files a UD action for the amount remaining due and unpaid.

The tenant claims the landlord cannot proceed with a UD hearing since neither the three-day notice nor the landlord’s receipt of the partial rent payment include a nonwaiver of rights provision.

Here, the nonresidential landlord may proceed with the UD action after receipt of partial rent. The nonwaiver provision in the lease agreement puts the tenant on notice, allowing the landlord to accept rent without waiving enforcement rights. One such right is the right to proceed with a UD action.5

A nonwaiver of rights provision in a three-day notice or partial payment agreement provides the landlord with the same right to proceed with the UD action as though the provision existed in the lease agreement.

On accepting a partial payment of rent after a UD action has been filed, the nonresidential landlord amends the UD complaint to reflect the partial payment received and the amount remaining due and unpaid by the tenant.6

Without a written partial payment agreement, tenants might claim the landlord who accepted partial rent:

- treated acceptance of partial rent as satisfaction of all the rent due;
- waived their right to continue eviction proceedings; or
- permanently modified the lease agreement, establishing a semi-monthly rent payment schedule.

When a residential or nonresidential landlord accepts a partial payment of rent, the evidence provided by a signed partial payment agreement overcomes tenant claims that the landlord waived UD enforcement rights by accepting rent.

4 CCP §1161.1(c)
6 CCP §1161.1(c)
The *partial payment agreement* entered into by a tenant and a landlord accepting partial rent memorializes:

- the landlord’s receipt of partial rent;
- the amount owed on the deferred portion of the delinquent rent;
- the tenant’s promise to pay the remaining rent owed on or before a specific date; and
- notification of the landlord’s right to serve a three-day notice on failure to pay the remaining balance. [See Form 559]
Consider a prudent residential tenant who informs the landlord they will be unable to pay the full monthly rent before the payment becomes delinquent. The tenant offers to pay part of the rent prior to delinquency and the remainder ten days later.

Since the tenant is creditworthy, has not been seriously delinquent in the past and the landlord wishes to retain the tenant, the residential landlord agrees to accept the partial payment.

However, to avoid disputes regarding the amount of rent remaining due and when it is to be paid, the residential landlord prepares and the landlord and tenant sign a partial payment agreement formalizing their understanding.

Now consider a residential landlord who serves a three-day notice and then accepts a partial payment of rent before completing the eviction process started by the notice. By accepting a partial payment, the residential landlord understands the three-day notice had been rendered invalid and no longer supports a UD action and eviction.

Thus, when the residential landlord accepts payment of partial rent it is on the condition the tenant enters into a partial payment agreement stating the date the balance owed is due. The partial payment agreement prevents disputes with the tenant about when the balance is due or a three-day notice may be served if the balance is not paid.
Acceptance of a partial payment toward delinquent rent is within the discretion of the landlord. Both residential and nonresidential landlords may accept a partial payment of delinquent rent. Different rules apply for nonresidential and residential partial rent payments.

A nonresidential landlord may accept a partial payment of rent after serving a three-day notice and before eviction. Without further notice to the tenant, the nonresidential landlord may proceed with a UD action and evict the tenant.

However, a residential landlord who accepts any amount of rent from a tenant after serving a three-day notice waives their right to use the notice as the basis for a UD action. After receiving partial rent, a residential landlord needs to serve the tenant with another three-day notice for the amount now remaining unpaid.

**Chapter 16 Key Terms**

- nonwaiver of rights provision ................................................. pg. 167
- partial payment agreement ...................................................... pg. 163
- reservation of rights ................................................................. pg. 164
Changing terms on a month-to-month tenancy

A landlord and tenant enter into a **month-to-month tenancy** under a rental agreement which grants an option to purchase the property. The option expires on termination of the tenancy.

Later, the landlord serves the tenant with a **30-day notice of a change in rental terms**. The notice states the option to purchase expires in 30 days, unless exercised by the tenant. [See Form 570 accompanying this chapter]

After the 30-day notice expires, the tenant, who is still in possession, attempts to exercise the option. In response, the landlord refuses to sell the property under the option. The landlord claims the tenant’s right to exercise the purchase option expired due to the change of rental terms in the 30-day notice.
The tenant claims the option to purchase is binding until the tenancy is terminated, and the month-to-month rental agreement and occupancy have not been terminated.

Can the tenant enforce the option to purchase?

No! The option expired, unexercised. The option to purchase was part of the terms of the rental agreement. Thus, on expiration of the 30-day notice terminating the option, the option to purchase was eliminated.

Like any other provision contained or referenced in a month-to-month rental agreement, the option to purchase is part of the tenant’s rights and obligations comprising the month-to-month tenancy. Thus, the option was subject to change on 30 days’ written notice from the landlord.¹

All conditions in a residential or nonresidential month-to-month rental agreement or expired lease agreement may be changed on written notice by the landlord. This notice is commonly referred to as a notice of change in rental terms.

The most common notice of change in rental terms requires a 30-day notice period. However, a 60-day notice period is required for residential rent increases greater than 10%. The 60-day notice is reviewed in a later subhead.²

Editor’s note — Conditions in a rental or lease agreement are also commonly referred to as provisions, clauses, terms, conditions, addenda, covenants, etc.

For example, a residential or nonresidential landlord under a month-to-month rental agreement can increase the rent or shift repair and maintenance obligations to the tenant by serving a 30-day notice of change in rental terms. It is also used to change any other terms in a residential month-to-month tenancy. For nonresidential property, the form is used regardless of the amount of the rent increase or to change any other terms. [See Form 570]

In addition to referencing the rental or expired lease agreement to be modified, the 30-day notice of change in rental terms provides for:

- change in the rent amount;
- change in the common area maintenance (CAM) charge;
- change in utility payment responsibility;
- additional security deposit;
- allocation of new or additional non-smoking areas; and
- a space for additional changes in the terms to the rental or expired lease agreement. [See Form 570]

¹ Wilcox v. Anderson (1978) 84 CA3d 593
² Calif. Civil Code §827
To be enforceable, a notice of change in rental terms is served in the same manner as a three-day notice to pay rent or quit. However, only the landlord may unilaterally change the terms in a rental agreement.\(^3\)

A month-to-month tenant has no ability to alter the terms of the rental agreement, other than to terminate the tenancy and vacate.\(^4\)
In rent control communities, a landlord or property manager needs to comply with rent control ordinances that affect their ability to alter provisions in leases and rental agreements, which is reviewed in a later subhead.

### Calculating rent due after an increase

A landlord or property manager may serve the tenant in possession under a periodic rental agreement with a notice of change in rental terms on any day during the rental period.
Once a notice of change in rental terms is served on a tenant, the new terms stated in the notice immediately become part of the tenant’s rental agreement or expired lease agreement, both being month-to-month tenancies.\(^5\)

However, the new rental terms stated in the notice do not take effect until expiration of the 30-day or 60-day period after service of the notice on the tenant.

For example, a property manager prepares a 30-day notice of change in rental terms to increase the rent on a month-to-month tenant. The due date for the payment of rent is the first day of each month.

The tenant is properly served with the 30-day notice on the 10th of June. The tenant intends to remain in possession at the new rent rate.

Since June 11\(^{th}\) is the first day of the 30-day notice period, the rent does not begin to accrue at the increased rate until July 11\(^{th}\) — the day after the 30-day notice expires. However, rent for all of July is payable in advance on the first day of the month, including the number of days affected by the rent increase.

To calculate the advance rent due and payable on the first day of July, the rent is prorated as follows:

- the old daily rate of rent for the first ten days of the month; and
- the new daily rate of rent for the remaining 20 days in the month of July.

*Pro rata rent* due on the first is determined based on the number of days in the calendar month, unless the rental agreement contains a provision prorating rent on a 30-day basis.

If a residential landlord decides to increase rent on a tenant under a month-to-month rental agreement, the length of the notice period depends on the amount of the rent increase. Two notices exist:

- the 30-day notice of change in rental terms [See Form 570]; and
- the 60-day notice of change in rental terms. [See *first tuesday* Form 574]

To determine whether a 30-day or 60-day notice is required, the landlord compares the increased rent sought with the lowest rent amount paid by the tenant during the last 12 months.\(^6\)

When the increase in monthly rent is equal to or less than 10% of the lowest amount of monthly rent paid during the previous 12 months, the landlord may serve the tenant with a 30-day notice of change in rental terms.

However, when the increase in rent is more than 10%, the landlord needs to serve the tenant with a 60-day notice of change in rental terms.\(^7\)

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\(^5\) CC §827  
\(^6\) Calif. Civil Code §827  
\(^7\) CC §827
For instance, consider a residential landlord charging a month-to-month tenant a rent of $1,000 per month. The tenant’s rent has not been increased during the last 12 months. The landlord now seeks to increase the monthly rent by $100. Since the total rent increase is not more than 10%, the landlord may serve the tenant with a 30-day notice to change the terms of the rental or expired lease agreement.

Now consider a different landlord and tenant situation. Within the past 12 months, the landlord increased the tenant’s monthly rent $50 from $950 to $1,000. The landlord currently seeks to increase the monthly rent by an additional $100. The anticipated $100 increase is compared to the lowest amount of rent paid in any month during the past 12 months to determine the percentage increase — the $950. Here, the increase in rent is 10.5%. Since the increase in rent is greater than 10%, the landlord needs to serve the tenant with a 60-day notice of a change in rental terms.

On being served with a notice of a change in rental terms, the month-to-month tenant has three options:

- remain in possession and comply with the new rental terms;
- serve the landlord with a 30-day notice of intent to vacate and continue paying rent through the end of the 30-day period to vacate [See Form 572 accompanying this chapter]; or
- remain in possession, refuse to comply with the rental terms and raise available defenses, such as retaliatory eviction, in the resulting unlawful detainer (UD) action. [See Chapter 21]

Consider the tenant who receives the landlord’s notice changing rental terms to increase the rent. The tenant does not wish to continue in possession at the increased rent amount. Accordingly, the tenant serves the landlord with a 30-day notice of intent to vacate. [See Form 572]

The tenant owes pro rata rent at the new rate for the days after the rent increase becomes effective through the date the tenant’s notice to vacate expires. The pro rata rent is payable in advance on the due date for the next scheduled payment of rent, usually the first.

In communities with low density and rent control, limitations on rent increases exist for older units.

Most rent control ordinances allow a landlord or property manager to increase the rent to:

- obtain a fair return on their investment;
- recover the cost of capital improvements to the property; and
- pass through the cost of servicing the debt on the property.

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8 CC §1946

9 CC §14
Thus, without further authority from the rent control board, a landlord whose property is subject to rent control may increase rent in one of three ways:

- increase rent by the maximum percentage set by local ordinance;
- increase rent by the maximum percentage of the consumer price index (CPI) as set by local ordinance; or
- increase rent by the maximum amount previously set by the local rent control board.

Landlords of newly constructed units or individual units (single family residences/condos) may establish their own rent rates, when they are subject to rent control ordinances established prior to 1995.
Notes:
After reading this chapter, you will be able to:

- distinguish a tenant’s real property right to occupy real estate versus the landlord’s independent contractual right to collect future rents;
- understand how a tenant’s right of possession can be terminated under a declaration of forfeiture provision in a three-day notice;
- appreciate how future rent is collected in a separate money action after a tenant’s possessory rights have been terminated; and
- instruct a landlord on loss mitigation measures to be implemented to recover future rents when a tenant vacates or is evicted.

**Key Terms**

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A tenant’s right to occupy real estate is a possessory estate in real property. It is conveyed by the landlord to the tenant by operation of the granting clause in a rental or lease agreement.

Once conveyed, the right of possession is owned by the tenant separate from the rental or lease agreement. The rental or lease agreements contain provisions creating contractual rights and obligations between the landlord and tenant. However, while the tenant holds the right granted to use and
occupy the rented property as a separate real property right from contract rights, the provisions of the rental or lease agreement control the terms and duration of the use and occupancy of the tenant’s possessory rights.

One contractual provision in rental or lease agreements is the **default remedies provision**. The default remedies provision creates the right for the landlord to collect rents for the full term of the lease. The landlord’s contractual right to collect future rents is independent of the tenant’s right of possession, continuing after possession is terminated based on the tenant’s material breach of the lease agreement. [See *first tuesday* Form 552]

Consider a tenant who fails to pay rent which becomes delinquent. The landlord serves the tenant with a three-day **notice to pay rent or quit**.

The notice contains a declaration of **forfeiture provision** stating the tenant’s right of possession — the real estate leasehold interest owned by the tenant — is forfeited on expiration of the three-day notice unless the tenant first pays the agreed rent. The declaration of forfeiture provision is also known as a **forfeiture-of-lease clause**.

Here, the “lease” subject to forfeiture is the property right of possession owned by the tenant, not the lease agreement entered into by the landlord and tenant (which is subject to cancellation, but never a forfeiture since an agreement is not property as is the right of possession). Confusingly, the lease agreement document, the paperwork itself, is often also loosely referred to as the “lease”, such as “this is the lease we signed.”

If the tenant fails to pay rent before the expiration of the notice, their possessory interest in the real estate is forfeited, as called for in the declaration or forfeiture provision in the notice. On forfeiture, the tenant voluntarily vacates. Alternatively, if the tenant remains in possession without the landlord’s consent, the tenant can be evicted through an unlawful detainer (UD) action. [See Form 575 §3 in Chapter 20]

However, the landlord does not file a UD action to regain possession of the property, even though the tenant’s continued possession is now unlawful and the landlord accepts no further rent.

*Editor’s note — The landlord may benefit by choosing not to evict the tenant when no other tenant is immediately available to occupy the space. If the lease agreement contains a **holdover rent provision** setting holdover rent rates, the landlord can pursue the tenant for holdover rents in a money action. Holdover rents usually greatly exceed the current rent rate for the space which is all the courts will award in UD actions. Further, occupancy is often required by insurance carriers to remain qualified for hazard coverage. [See Sidebar, “A holdover tenancy”]*

The tenant later voluntarily vacates the property prior to expiration of the lease.
The landlord then files a separate civil action against the tenant to collect rent for:

- the period prior to termination of the right of possession by forfeiture as declared in the three-day notice;
- the holdover period after the forfeiture of possession and prior to vacating; and
- the remaining period under the lease agreement after the tenant vacated until expiration of the lease.

The tenant claims the landlord cannot collect rent called for in the lease agreement for any period after expiration of the three-day notice since:

- the election to forfeit the lease contained in the three-day notice to pay or quit did not just terminate the tenant’s real property right to occupy, but cancelled the contractual lease agreement; and
- the landlord’s failure to evict the tenant on cancellation of the lease agreement converted the tenant’s continued occupancy into a periodic tenancy for which reasonable rent is due, not the holdover rent set in the lease agreement.

Can the landlord collect all rent unpaid as agreed during the tenant’s occupancy as well as future rent due for the remaining term of the lease even though the lease was forfeited in the three-day notice?

Yes! But before proceeding, an extremely important distinction needs to be made between:

- the tenant’s real property right of possession, called a lease, or a leasehold interest as an estate in real property [See Chapter 1]; and
- the tenant’s holdover tenancy.
the lease agreement, which grants the landlord a contract right to collect rents, also commonly referred to as a lease.\(^1\)

A three-day notice to pay or quit that includes a declaration of forfeiture provision terminates the tenant's real property right of possession. It does not also cancel the contract which is the lease agreement. The lease agreement remains intact on forfeiture of possession.\(^2\) [See Chapter 1]

Also, a landlord need not first evict the holdover tenant in a UD action before filing a separate money action to recover rents called for in the lease agreement. Remember, the right of possession and the contractual rights and obligations agreed to in the lease agreement are enforced separately, independent of one another.

Once the tenant's right of possession has expired or been terminated, the landlord can demand and recover holdover rents and unearned future rents remaining under the lease agreement.\(^3\)

"Termination of the lease" by forfeiture refers exclusively to the termination of the tenant's right of possession in the real estate. Again, the lease agreement remains enforceable to collect unpaid past rents and future rents; it was not cancelled and is unaffected by the termination by forfeiture of the tenant's property rights, with or without the tenant being evicted.

With the tenant's right of possession terminated by the declaration of forfeiture provision in the three-day notice, the landlord may at any time file a UD action and recover possession.\(^4\)

In a UD action, the court initially determines whether the termination of the right of possession under the three-day notice was proper. If proper and the tenant did not cure the breach before the forfeiture became effective, the landlord is awarded possession and the tenant evicted. [See Sidebar, “Abandonment: a passive alternative”]

Rent earned and unpaid up to the time of the UD trial may be awarded in the UD action along with an eviction order. The UD money award for rent due applies only to periods before the UD trial, including:

- the period before termination of the lease for delinquent rent at the rate set by the lease agreement; and
- during the holdover period after termination of the tenant's right of possession up to the UD trial for rent of a reasonable amount as determined by the court.

**Editor's note — Typically, UD courts will only award the landlord reasonable rent for rent due in a holdover period. If a lease agreement contains a holdover rent provision, the landlord may consider limiting their recovery**

\(^1\) Walt v. Superior Court (1992) 8 CA4th 1667
\(^2\) Danner v. Jarrett (1983) 144 CA3d 164
\(^3\) Walt, supra
\(^4\) Calif. Code of Civil Procedure §§1161.1; 1174(c)
in the UD action to a simple recovery of possession. Then, the landlord may file a separate money action to recover the holdover rents due, at the holdover rent rate set in the lease agreement.

A UD award does not include future, unearned rent. Future rents are collected through a separate money action on the lease agreement filed after the tenant has been evicted and mitigation of losses undertaken by the landlord.

To review: a landlord who needs to evict a tenant by a UD action may recover possession based on either:

- a termination of the tenant’s right of possession under a declaration of forfeiture provision in a three-day notice; or
- leaving the declaration of forfeiture provision out of the three-day notice and allowing the court to terminate the lease on expiration of a five-day reinstatement period following a UD award.\(^5\)

With a declaration of forfeiture provision in the three-day notice, the tenant who fails to cure the breach has no continuing right to occupy the real estate after the notice expires.\(^6\)

But what if the three-day notice did not include a declaration of forfeiture provision, deliberately deleted or not? Without including the declaration of forfeiture provision in a notice to quit, the right of possession — the lease — is not terminated until five days has passed after the UD judgment is entered. During this period, called the reinstatement period, the tenant may reinstate their yet unforfeited right of possession if they meet the terms set by the UD judgment. If the terms are not met within the reinstatement period of five days, the lease is then forfeited and the tenant evicted.\(^7\)

A landlord might deliberately remove the declaration of forfeiture provision from a three-day notice to give a good tenant extra time to bring overdue rent current. A landlord who deletes the declaration of forfeiture provision effectively gives their tenant the three-day notice period, the length of the UD court process and the five-day reinstatement period to bring the rent current.

If the tenant is able to bring the rent current, the landlord benefits by keeping an otherwise suitable tenant and avoiding a vacancy and turnover costs.

A tenant has no ability to unilaterally restore their right of possession after their leasehold estate in the property has been terminated by forfeiture. Only a court order, or a mutual agreement with the landlord, can restore the tenant’s right of possession once terminated.

The relief from forfeiture is sought primarily by nonresidential tenants who have long-term leases and are prepared to cure any defaults.

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\(^5\) CCP §1174(a)(c)
\(^6\) CCP §1174(a)
\(^7\) CC §1174(c)
A tenant who wishes to remain in possession after their right of possession has been forfeited and they have been evicted by UD action may petition the court to restore their right of possession, if:

- the underlying lease had an original term of more than one year;
- the landlord has not retaken possession of the property;
- the tenant has not been removed by the sheriff; and
- the tenant petitions the UD court for relief.\(^8\)

Whether the court will grant the tenant a relief from forfeiture and a reinstatement of the lease is based on the degree of hardship the tenant suffers if evicted. However, if the court does grant the tenant relief from forfeiture, it will be conditioned on:

- the payment of all amounts, including rents, due the landlord; and
- full performance of all rental or lease agreement conditions, whether oral or written.

Also, when the right of possession has already been terminated by a declaration of forfeiture provision in the three-day notice does not concern the court when hearing the tenant’s petition for relief from forfeiture.\(^9\)

If an attorney appears on behalf of the tenant seeking relief from forfeiture, a copy of the application for relief and petition for the hearing is to be served on the landlord or property manager filing the UD action at least five days prior to the hearing.\(^10\)

Also, at the UD trial, the landlord needs to be prepared to defend the forfeiture they have declared. This will entail explaining why relief from the forfeiture is unfair to the landlord. The landlord is also required to detail the amounts owed and lease/rental conditions to be cured. The court in a UD action may initiate an inquiry on its own into whether the tenant is entitled to relief from forfeiture.

Also, the tenant may orally request the court at the UD trial to be relieved of the forfeiture and allowed (on conditions) to remain in possession.

On termination of the tenant’s possessory right to the property — the leasehold— under a declaration of forfeiture provision in any three-day notice or at trial, the landlord is entitled to:

- file a UD action to physically remove the defaulting tenant from actual possession, called eviction;
- enforce collection of rent earned and unpaid through entry of the UD judgment; and
- file a separate money action to recover future rents and any prior unpaid rent earned but not included in the UD judgment.

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8 CCP §1179
9 CCP §1179
10 CCP §1179
Instead of or in addition to beginning the eviction process by serving a three-day notice with a declaration of forfeiture, a landlord may choose to sever the possession through the abandonment process. [CC §1951.3; see first tuesday Form 581]

To begin recovering possession through abandonment, a landlord serves a notice of abandonment on the tenant. This notice is served if:

- rent on the leased property has been due and unpaid for at least 14 days from the due date;
- the landlord has a reasonable belief that the tenant has abandoned the property. [Calif. Civil Code §1951.3(b)]

A notice of abandonment declares the tenant’s right of possession (but not the rental or lease agreement) will be terminated due to abandonment on expiration of the notice. A tenant may contest the abandonment within:

- 15 days of the tenant receiving personal service of the notice of abandonment; or
- 18 days after the notice is placed in the mail by the landlord. [CC §1951.3.(b)]

If the tenant does not contest the notice of abandonment within the statutory time limit, the landlord has terminated the tenant’s right of possession. Remember: the rental or lease agreement remains intact and survives the tenant’s loss of possession. Thus, the landlord retains the contract right to collect future rents due under the uncancelled rental or lease agreement.

Serving a notice of abandonment by itself can have significant negative impacts for a landlord. Firstly, it takes 18 days to terminate a tenant’s right of possession, as opposed to three days under the three-day notice.

Secondly, the notice of abandonment only addresses a failure to pay rent. It is not triggered by, nor does it address any material breach by the tenant. A three-day notice to quit is triggered by a material breach of the rental or lease agreement.

Thirdly, the landlord’s service of an abandonment notice is an inherently passive process. The landlord serves the notice, and effectively waits for the tenant to contest the landlord’s notice. The tenant need not take any action to first cure any breach. Contrast this with the three-day notice and the eviction process, in which the tenant is required to cure the breach, or the right of possession is terminated.

Sidebar
Abandonment: a passive alternative

Editor’s note — Of course, double recovery of rent is not allowed. If the landlord, in their UD action, is awarded (or denied) rents accrued prior to the UD award, the landlord cannot again seek to recover those amounts in the separate money action for rents.

In a money action to collect future rents separate from any UD action or other remedies permitted by the lease agreement, the landlord is entitled to recover:

- all unpaid rent earned under the lease agreement up until the tenant’s right of possession is terminated¹¹;
- reasonable per diem rent from the termination of the right of possession, until entry of the judgment for rent¹²;

¹¹ CC §1951.2(a)(1)
¹² CC §1951.2(a)(2)
• all unearned rent called for in the lease agreement for the remaining unexpired term of the lease, subject to:
  ° loss mitigation;
  ° default remedies in the lease agreement;
  ° the prior reletting of the premises; and
  ° the discounted present worth of the future rent;¹³
• costs incurred by the landlord as a result of the tenant’s breach;¹⁴ and
• attorney fees incurred if the lease agreement contains an attorney fees provision.¹⁵

If the lease agreement included a default remedies provision, the separate money action to recover future rents can be filed immediately after the tenant’s right of possession terminated. Recall from the opening scenario that a default remedies provision reserves the landlord’s right to collect future rent due after the tenant’s right of possession has been terminated. [See Figure 1]

If the lease agreement does not contain a default remedies clause, the landlord’s right to recover future rents is still allowed by statute as laid out above. This type of recovery of rents is called a statutory recovery. However, in a statutory recovery the landlord is required to first mitigate their losses by reletting the premises. Only after reletting the premises may the landlord file a money action to recover future rents due from the evicted tenant.¹⁶

With or without a default remedies provision in the lease agreement, the landlord who seeks to recover future rents is to make a reasonable, good-faith effort to reduce their loss of rent after the tenant vacates or is evicted. This is known as loss mitigation, a requisite to recovery of future rents.

If the landlord does not act to reduce loss of future rental income, a tenant has the right to offset any future rent due by the amount of rent the landlord could have reasonably collected by reletting the space.¹⁷

Consider a tenant who fails to pay rent as scheduled in the lease agreement.

Ultimately, a UD judgment is entered in the landlord’s favor. The tenant is evicted by the sheriff under a writ of possession issued by the court.

The landlord repossesses the property. Then, the landlord takes steps to relet the property. During the effort to relet, the evicted tenant offers to lease the property at the old rent rate. The landlord refuses the evicted tenant’s offer, opting to relet the property to a more creditworthy tenant at a lower rent rate.

¹³ CC §1951.20(3)
¹⁴ CC §1951.20(4)
¹⁵ CC §1717
¹⁶ CC §1951.20(c)
¹⁷ CC §1951.20(c)
The landlord then seeks to recover their money losses from the evicted tenant. The losses equal the difference between:

- the amount of rent agreed to and unpaid through the expiration of the lease term in the lease agreement; and
- the amount of rent the new tenant has agreed to pay.

The evicted tenant claims the landlord is barred from collecting any unpaid future rent since the landlord could have recovered the full amount of rental payments if the landlord had accepted the evicted tenant’s offer to lease.

Is the evicted tenant liable for the deficiency created by the difference between all rent remaining unpaid on the lease and the amount of rent the new tenant has agreed to pay?

Yes! The evicted tenant owes the deficiency between the rent owed under the tenant’s lease agreement and the lower rent to be paid by the new tenant. Here, the landlord actively sought a new tenant and was unable to get the full amount of the rent the evicted tenant had agreed to pay through the expiration of their lease.\(^\text{18}\)

The landlord’s effort to mitigate the loss of rents by reletting the property was in good faith and reasonable. The reasonableness of the landlord’s conduct undertaken to relet the space is determined based on the actions actually taken by the landlord. Reasonableness is not determined by evaluating available alternative courses of action the landlord could have taken to mitigate damages (such as re-renting to the evicted tenant).

A landlord needs to pursue a course of action that is likely to reduce the amount of future rent the evicted tenant owes after the tenancy is terminated. Otherwise, the tenant is permitted to offset future rents by showing the landlord’s efforts to relet the property were unreasonable efforts to mitigate the loss of rent.

The landlord who is entitled to recover future rent under an unexpired lease agreement will only be awarded the present value of the unearned future rents.

To determine the present value of unearned rent at the time of the court’s money award, the future rents will be discounted (to their present value) at the annual rate of 1\% over the Federal Reserve Bank of San Francisco (the Fed’s discount rate. The Fed’s discount rate used for calculating the present worth of future rent on an award in 2014 would be 1\% over the discount rate of 0.75\%.\(^\text{19}\)

From the time the tenant defaults on the payment of rent to the time the unpaid rent is awarded, the landlord is entitled to recover interest on unpaid amounts of back rent.


\(^{19}\) CC §1951.2(b)
The interest accrued prior to judgment is calculated at the rate agreed to in the lease agreement. If the interest rate is not stated in the lease agreement, the interest will accrue at 10% per annum from the date of default to entry of the money judgment. After judgment is awarded for back rent or discounted future rent, interest accrues at 10% on the money judgment until paid.20

**Costs to relet**

A landlord is entitled to recover all reasonable costs incurred to relet the property once a tenant has prematurely vacated, or been evicted.21

Costs incurred to relet the property include:

- costs to clean up the property;
- brokerage and legal fees to find a new tenant;
- permit fees to construct necessary improvements or renovations; and
- any other money losses incurred as a result of the tenant’s breach, such as a decline in the property’s market value.22

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20 CC §§1951.2(b), 3289
21 CC §§1951.2(a)(4)

**Chapter 18 Summary**

A tenant’s right to occupy real estate is a possessory estate in real property. It is conveyed by the landlord to the tenant by operation of the granting clause in a rental or lease agreement.

Once conveyed, the right of possession is owned by the tenant separate from the rental or lease agreement. The rental or lease agreements contain provisions creating contractual rights and obligations between the landlord and tenant. However, while the tenant holds the right to use and occupy a rented property as a separate real property right, the provisions of the rental or lease agreement control the terms and duration of the use and occupancy.

A landlord who needs to evict a tenant by an unlawful detainer (UD) action may recover possession based on either:

- a termination of the tenant’s right of possession under a declaration of forfeiture provision in a three-day notice; or
- leaving the declaration of forfeiture provision out of the three-day notice and allowing the court to terminate the lease on expiration of the five-day reinstatement period following a UD award.

Rent earned and unpaid up to the time of the UD trial may be awarded in the UD action along with an eviction order. A UD award does not include future, unearned rent, which is collected through a separate money action on the lease agreement.
The landlord who seeks to recover future rents is to make a reasonable, good-faith effort to reduce their loss of rent after the tenant vacates or is evicted, known as loss mitigation. The landlord who is entitled to recover future rent under an unexpired lease agreement will only be awarded the present value of the unearned future rents. To determine the present value of unearned rent, the future rents will be discounted to their present value at the annual rate of 1% over the Federal Reserve Bank of San Francisco (the Fed)'s discount rate.
Notes:
Chapter 19: Surrender cancels the lease agreement

After reading this chapter, you will be able to:

- identify a surrender as a cancellation of the lease agreement by the landlord when the tenant returns possession of the leased premises;
- use a written surrender to mutually terminate a lease agreement and release the tenant and landlord from any further obligations; and
- distinguish a landlord’s inability to collect future rent on a surrender from the landlord’s right to collect future rent when a tenant breaches and the landlord forfeits the tenant’s right to possession.

**Learning Objectives**

**Key Terms**

- early-termination fee
- surrender

**Lost ability to recover future rents**

Before a nonresidential lease expires, the tenant closes out their business operations and vacates the premises, paying no further rent. The landlord serves the tenant with a three-day *notice to pay rent or quit*. [See Form 575 in Chapter 20]

The notice includes a clause declaring a forfeiture of the lease if the tenant fails to pay rent within three days following service of the notice.

The tenant responds to the notice by letter, stating they elect not to pay future rent and accept the landlord’s offer to terminate the lease. The key to the premises is returned to the landlord with the letter.

The landlord responds by letter stating:

- neither the landlord nor the tenant owe each other any further obligations under the lease; and
• the tenant is to pay all rent due up to the date the tenant returned the key to the landlord.

The landlord then attempts to relet the premises, but without success.

Later, the landlord makes a demand on the tenant for payment of rents called for in the lease agreement for the entire remaining term of the lease. The landlord claims the forfeiture of the lease in the three-day notice terminated the tenant’s right of possession but did not cancel the lease agreement.

The tenant claims the landlord is not entitled to any future rents called for in the lease agreement since the landlord agreed that neither the tenant nor the landlord owed any further obligation under the lease agreement.

May the landlord recover future rents from the tenant based on the lease agreement, notices and letters?

No! The lease agreement was cancelled by the communications agreeing to terminate all obligations under the lease agreement in exchange for possession. Therefore, the lease agreement was no longer enforceable.1

Continuing our previous example, the tenant’s letter “electing to pay no future rent” coupled with the return of the key to the landlord initiated a surrender. It signified an implied offer to cancel the lease agreement.

The landlord’s affirmative response to the tenant’s letter foregoing future rents released the tenant from further liability on the lease agreement. The landlord’s conduct constituted acceptance of the tenant’s offer to cancel the lease agreement obligations.

Editor’s Note: the declaration of forfeiture did reserve the landlord’s right to collect future rents under the lease agreement from the tenant. However, the landlord later effectively cancelled the lease agreement by their conduct in agreeing to the tenant’s offer to pay no future rent on return of the keys.2

Consider a tenant who breaches a nonresidential lease agreement before the lease expires and vacates the premises without the landlord’s service of a three-day notice to quit on the tenant. The landlord may respond by taking possession in one of four ways:

• terminate the tenant’s right of possession and cancel the lease agreement by a surrender, then take possession and relet the premises to others or occupy the premises as the owner [See Form 587 accompanying this chapter];

• terminate the tenant’s right of possession using a three-day notice containing a declaration of forfeiture (or a notice of abandonment),

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1 Desert Plaza Partnership v. Waddell (1986) 180 CA3d 805
2 Calif. Civil Code §1951.2
take possession and relet the premises to mitigate losses before making a demand for payment of future rents [See Chapter 18; see first tuesday Form 575 and 581];

- take possession of the premises and relet it on the tenant’s behalf, then collect any monthly losses from the tenant; or
- enforce any tenant-mitigation provision in the lease agreement, leaving possession with the tenant to relet the premises to mitigate the tenant’s losses. [See Chapter 34]

Only ownership of a real estate interest, such as a leasehold interest, and personal property may be forfeited. However, a contract, such as a lease agreement, is not property. A contract is evidence of rights and obligations. Thus, it may be cancelled, but it cannot be the subject of a forfeiture.

A surrender occurs when:

- a tenant breaches a lease or rental agreement and vacates or intends to vacate the premises; and
- the landlord agrees to accept a return of possession from the tenant in exchange for cancelling the lease agreement.

The cancellation of the lease agreement in a surrender situation occurs by either:

- mutual consent of the landlord and the tenant;³ or
- operation of law, implied due to the conduct of the landlord.

Editor’s note — Avoiding an unintentional surrender is one of the many reasons why a landlord needs to understand the difference between terminating a right of possession (the forfeiture of possession aspect) and the separate act of terminating a lease agreement (the cancellation of the right to future rents). [See Chapter 18]

For a landlord to avoid adverse legal consequences when a tenant prematurely vacates, lease agreements contain a remedies provision stating a surrender occurs only if the tenant enters into a written cancellation and waiver agreement. [See first tuesday Form 552 §2.4]

The Termination of Lease and Surrender Agreement by first tuesday provides the writing used to mutually terminate a lease agreement and release the tenant and landlord from any further obligations and liability under the lease agreement. [See Form 587]

Lease termination and surrender agreement provisions include:

- the termination date on which the tenant is to quit and surrender possession of the premises to the landlord [See Form 587 §2];
- a release between the landlord and tenant from all claims and obligations, known or unknown, arising out of the lease agreement and possession [See Form 587 §2.1];

³ CC §1933(2)
any monetary consideration remaining to be paid by the tenant to the landlord [See Form 587 §2.2];

- a description of any conditions to be performed prior to cancellation, which may include any payment the landlord will make to the tenant, such as a return of deposit, prepaid rent or settlement money on a dispute [See Form 587 §2.3]; and

- conditions pertaining to a subtenant, if any, that needs to be arranged and agreed to. [See Form 587 §2.4]
Consider a tenant who makes a written offer to surrender the leased premises to the landlord.

The landlord believes a new tenant, who will pay more rent for the space than the current tenant, can be quickly located.

Still, the landlord demands an early-termination fee equal to three months’ rent to cancel the lease agreement. The tenant pays the fee and delivers possession, and the acceptance by the landlord cancels the lease. A surrender has occurred. [See Form 587 §2.2]

Editor’s note — Mid-term leases sometimes contain an early-termination provision for a surrender. The provision allows the tenant to cancel the lease agreement on payment of a fee. This termination fee usually is in the amount of two to six months’ unearned rent. This is a type of prepayment bonus or liability limitation provision seen in mortgages and purchase agreements.

Under an early termination provision, a surrender functions like a deed-in-lieu of foreclosure that conveys the real estate to the lender (possession returned to the landlord) in exchange for the lender's cancellation of the note obligations (cancellation of the lease agreement).

Now consider a tenant on a lease with a ten-year term. A few years after entering into the lease agreement, the tenant vacates the premises. The tenant removes all of their personal property and returns the key to the landlord. The tenant has no intention of returning and has breached the lease agreement by failing to pay rent.

Since a surrender cancels the landlord’s right to future rents due under the lease agreement, the landlord refuses to treat the tenant’s return of possession as a surrender.

To avoid a surrender, the landlord promptly informs the tenant they intend to enforce collection of future rent due by the terms of the lease agreement.

Without prior notice to the tenant, the landlord retakes possession, refurbishes the vacated space and leases it to a replacement tenant. The new lease agreement with the replacement tenant is for a lower rent rate than the prior tenant paid under the breached lease. The landlord notifies the prior tenant they have leased the premises to mitigate their loss of rent.

The landlord makes a demand on the prior tenant for the payment of rent. The rent demanded is the difference between:

- the total amount of rents remaining unpaid over the remaining unexpired term of the prior tenant’s lease; and
- the amount of rent to be paid during the same period under the new lease by the replacement tenant.

Can the landlord recover the lost rent from the prior tenant who vacated the premises and returned possession to the landlord?
No! Before entering the space to prepare for reletting the premises, the landlord failed to:

- **terminate the tenancy** by serving a three-day notice with a declaration of forfeiture (or a notice of abandonment); or
- **notify the tenant** they were taking possession of the premises as an agent acting on the tenant’s behalf.

The conduct of the landlord at the time they unilaterally took possession to relet the premises violated the tenant’s unforfeited and continuing right of possession. Although the landlord did not intend to accept a surrender, they did so by taking possession without first forfeiting the tenant’s leasehold (or advising the tenant of the landlord’s intent to act on the tenant’s behalf to relet the premises).

Here, a surrender by operation of law occurred. The landlord took possession while the tenant still retained their possessory interest in the property as granted by the lease agreement.

Thus, the landlord’s interference with the tenant’s remaining right of possession constitutes an acceptance by the landlord of an implied offer to surrender initiated by the tenant’s vacating the premises.

The result is the tenancy is terminated and the lease agreement cancelled by surrender. This result is avoided when the landlord first serves notice terminating the tenant’s right of possession with a declaration of forfeiture provision.¹ [See Case in point, “Surrender on failure to declare a forfeiture”]

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4. **Dorcich v. Time Oil Co. (1951) 103 CA2d 677**
Here, the landlord omits the declaration of forfeiture from the three-day notice since the landlord intends to leave the tenant's right of possession intact.

Although no longer physically occupying the property, the tenant still owns the leasehold interest in the property and the lease agreement remains enforceable as it has not been cancelled. However, the use and occupancy of the premises is now managed by the landlord on the tenant's behalf.

The landlord who intends to take possession and relet the premises as the tenant's agent notifies the tenant about their agency actions twice:

• once before taking possession of the premises; and
• again when the premises is relet.

Even though a tenant fails to pay rent, removes all of their personal property, vacates the leased premises and has no intention of returning, the tenant cannot unilaterally terminate their right to continued possession of the premises, much less escape the obligations to pay future rents called for in the lease agreement.

Until the tenant's right of possession is terminated by a three-day notice containing a declaration of forfeiture provision (or abandonment) served on the tenant by the landlord, no person other than the tenant has the right to occupy the premises.

However, the landlord who does not forfeit the tenant’s right of possession may establish themselves as the agent of the tenant who has vacated. This is done in an effort to preserve the landlord’s reversionary interest from waste.

Consider a tenant who has breached their lease agreement and vacated the premises. The landlord notifies the tenant that the landlord will enter the premises, take possession and relet the premises as the tenant's agent.

The landlord relets the premises for less rent, but for a period extending beyond the expiration of the tenant’s lease. The landlord notifies the tenant they have relet the premises on the tenant's behalf.

The landlord then makes a demand on the tenant for the loss in rent resulting from the reletting of the premises at a reduced rent. The tenant refuses to pay since the terms of the lease granted to the new tenant by the landlord exceeded the term of the tenant’s remaining right of possession under the breached lease agreement.

Here, the tenant's right of possession which remains unterminated runs only until the expiration of the period fixed by the lease agreement. Had the vacating tenant sought to sublet the premises, the term of the sublease may not extend beyond the expiration date of the tenant’s lease.
Thus, the landlord who acts to relet the premises as the tenant’s agent for a longer term than the unexpired term remaining on the lease:

- is not renting the premises on behalf of the tenant; and
- has worked a surrender due to conduct inconsistent with the vacating tenant’s unexpired and unterminated right of possession.\(^5\)

Now consider a landlord who, on notice to a vacating tenant, takes possession on behalf of the tenant. The landlord maintains and cares for the vacated premises while attempting to relet the premises.

The tenant claims the landlord’s care and maintenance of the property constitutes a surrender since the landlord exercised independent control over the premises by their maintenance activity.

However, the landlord has not surrendered the property merely by maintaining it to prevent waste. Acting as the agent of the vacated tenant, the landlord undertakes an obligation to make a good faith effort to lease the premises, called loss mitigation. This duty requires the landlord to keep the premises properly maintained. Care and maintenance of the property is activity consistent with the landlord’s agency duty owed the tenant when acting on the tenant’s behalf.\(^6\)

To avoid adverse legal consequences when a tenant prematurely vacates, lease agreements contain a remedies provision stating a surrender can occur only if the tenant enters into a written cancellation and waiver agreement. [See \textit{first tuesday} Form 552 §2.4]

However, the landlord’s conduct regarding possession in response to a tenant’s breach of the lease agreement and vacating of the premises can result in a cancellation of the lease by surrender.

A landlord’s conduct supersedes the lease agreement provisions requiring a written agreement to cancel the lease. Landlord/tenant law controls the results of conduct, barring application of contract law principles that ignore the landlord’s inconsistent conduct.

\(^5\) Welcome \textit{v.} Hess (1891) 90 C 507

\(^6\) B.K.K. Company \textit{v.} Schultz (1970) 7 CA3d 786
A surrender occurs when:

- a tenant breaches a lease or rental agreement and vacates or intends to vacate the premises; and
- the landlord agrees to accept a return of possession from the tenant in exchange for cancelling the lease agreement.

The cancellation of the lease agreement in a surrender situation occurs by either:

- mutual consent of the landlord and the tenant; or
- operation of law, implied due to the conduct of the landlord.

When a tenant breaches the lease agreement and vacates the premises without the landlord’s service of a three-day notice to quit on the tenant, the landlord may respond to possession in one of four ways:

- terminate the tenant’s right of possession and cancel the lease agreement by a surrender, then relet the premises to others or occupy the premises as the owner;
- terminate the tenant’s right of possession using a three-day notice containing a declaration of forfeiture (or a notice of abandonment), take possession and relet the premises to mitigate losses before making a demand for payment of future rents;
- take possession of the premises and relet it on the tenant’s behalf, then collect any monthly losses from the tenant; or
- enforce any tenant-mitigation provision in the lease agreement, leaving the tenant in possession to relet the premises to mitigate the tenant’s losses.

**Key Terms**

- early-termination provision .................................................... pg. 285
- surrender ..................................................................................... pg. 192
A tenant fails to pay rent on or after the due date and expiration of the grace period set in the rental or lease agreement. The rent is now delinquent. The property manager serves the tenant with a three-day notice to pay rent or quit. [See Form 575 accompanying this chapter]

The three-day notice states the exact amount of:

- delinquent rent unpaid; and
- other delinquent amounts owed to the landlord and unpaid.
Editor’s note — Some trial judges declare late charges and rent-related fees are not rent in residential agreements. Thus, the delinquency of a late charge payment or rent-related fee properly demanded and unpaid is not properly included as an amount due a residential landlord to be collected by use of a three-day notice to pay or quit. Further, they are not a material breach of the rental or lease agreement.

Before a landlord or a property manager includes any late charge (or other amounts due besides technical rent) in a three-day notice as part of the total amount due, the wise landlord will determine if the judge presiding over UD actions in the jurisdiction will allow a demand for late charges. [See Chapter 22; see first tuesday Form 575-1]

The three-day notice also contains a critical declaration of forfeiture provision. The forfeiture provision states the tenant’s failure to pay the delinquent rent before the notice expires causes the right of possession of the property to revert to the landlord by forfeiture.

After the three-day notice expires, the tenant remains in possession. Later, the tenant tenders payment of the delinquent rent to the landlord. The landlord refuses to accept the payment. The tenant refuses to voluntarily vacate.

The landlord files an unlawful detainer (UD) action to evict the tenant and regain possession of the premises. The landlord claims the tenant’s right of possession was terminated on expiration of the three-day notice due to the declaration of forfeiture provision it contained. Thus, the tenant cannot now reinstate their terminated right of possession by paying the delinquent rent.

Can the landlord evict the tenant even though the tenant tendered the delinquent rent in full after expiration of the three-day notice?

Yes! The tenant’s right of possession was terminated on expiration of the three-day notice since the notice contained a declaration of forfeiture provision. Thus, the tenant’s continued occupancy became unlawful on expiration of the three-day notice.1

On expiration, the landlord is no longer obligated to accept delinquent rent payments or allow the occupancy to be reinstated. Even though the right to possession has been terminated by forfeiture, the rental or lease agreement has not been cancelled (remember, contract rights cannot be forfeited). The rental or lease agreement remains enforceable to collect future rents as scheduled.2 [See Form 575 §5.1]

A tenant defaults on their rental or lease agreement by failing to:

- pay rent and any other amounts due and called for in the rental or lease agreement; or

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1 Calif. Code of Civil Procedure § 1174(a)
2 CCP §§ 1161(2); 1174(a)
perform nonmonetary obligations called for in the rental or lease agreement.

On a tenant’s default, the landlord may make a demand on the tenant to cure the default or vacate the premises.

However, only a **material breach** allows the landlord to forfeit the tenant’s right of possession. [See Case in point, “When is a failure to perform an eviction-worthy breach?”]
Failure to pay rent or perform other significant obligations called for in the rental or lease agreement is a material breach. Conversely, the tenant’s failure to pay late charges, interest penalties, bad check charges or security deposits are minor breaches, which alone do not justify a three-day notice to cure or quit. ³

Some nonmonetary defaults by a tenant cannot be cured. These are known as incurable breaches. Incurable breaches include:

- waste to the premises;
- alienation of the leasehold; or
- significant criminal activity which has occurred on the property.

The landlord’s remedy for an incurable breach is to serve notice on the tenant to quit the premises within three days after service. The tenant has no alternative but to vacate. Here, a declaration of forfeiture provision accompanying the three-day notice is unnecessary and ineffective since the failure cannot be cured and the tenancy cannot be reinstated. ⁴

After a landlord serves a tenant with a three-day notice to pay rent or quit, containing a declaration of forfeiture provision, the tenant is required to cure the breach in three calendar days to avoid loss of their right to possession and eventual eviction. (The first day in the three-day period is the day after service of the notice.) ⁵

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³ *Keating v. Preston* (1940) 42 CA2d 110
⁴ CCP §1161(4)
⁵ Cal. Civil Code §10
The tenant cures the default, retaining the right of possession by paying the amount stated before the three-day notice expires.6

The tenant may tender payment of the delinquent rent in the same manner the tenant made past rental payments — by personal or business check, money order, cashier’s check, credit card, cash or electronic transfer.7

Rent paid by check and timely received by the landlord becomes delinquent when the check is returned due to insufficient funds and replacement funds are not received within the established grace period. With rent now delinquent, the landlord may serve a three-day notice to pay or quit.

Editor’s note — Under a month-to-month rental agreement, the landlord may modify the tenant’s method of payment by serving the tenant with a written 30-day notice of a change in rental terms.8 [See Chapter 17]

To cure a delinquency, the tenant’s delinquent rent payment needs to be received by the landlord. For instance, when a check for delinquent rent is returned because of insufficient funds, the delinquent rent demanded in a three-day notice has not been paid. Unless the tenant actually pays the delinquent rent and it is received by the landlord prior to expiration of the notice, the tenant’s right of possession will be terminated under the declaration of forfeiture provision. At that point, the landlord may file a UD action if the tenant remains in possession.

Editor’s note — A landlord can require payment of rent in cash if a tenant’s check is returned for insufficient funds. However, this cash-only requirement may not extend longer than three months. After that period, the landlord is required to again accept alternate forms of payment.9 [See first tuesday Form 552 §3.10]

A three-day notice may only demand rents which became due during the one year prior to the date of service. If a three-day notice demands delinquent rents which have been due for more than one year, the notice is defective and will not terminate the right of possession or support a UD action. More rent has been demanded than will be awarded by a court in a UD action. Thus, any UD action based on a notice demanding rent for delinquencies more than a year old will fail.10

The landlord may recover rents and other amounts more than one year delinquent by pursuing collection in a money action separate from the UD action. A landlord is allowed four years to bring a civil action to recover due and unpaid amounts.11

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6 CCP §1161.5
7 Strom v. Union Oil Co. (1948) 88 CA2d 78
8 CC §5827
9 CC §1947.3
10 Bevill v. Zoura (1994) 27 CA4th 694
11 CCP §9337
Before serving a tenant with a three-day notice to pay rent or quit, the landlord or property manager needs to consider the following questions:

- Is the rent delinquent?
- What amounts are due and unpaid?
- When can delinquent rent be estimated in the three-day notice?
- What is a reasonable estimate of unknown but delinquent rent?
- When does the three-day notice expire?
- When does the tenant’s right of possession terminate?
- Is the rental or lease agreement cancelled? and
- How are subtenants evicted?

Rent needs to be delinquent before a three-day notice to pay or quit may be served.

Rent becomes delinquent:

- the business day following the due date, unless a grace period is established in the rental or lease agreement; or
- the business day following the last calendar day of the grace period established in the rental or lease agreement.

A grace period is the time period following the due date during which rent may be paid without incurring a late charge. While rent is past due and unpaid, it is not delinquent until the grace period expires.

When a grace period exists and the day scheduled for payment of rent falls on a legal holiday, the payment is not delinquent if it is tendered on the next business day. For purposes of paying rent, legal holidays include:

- Saturdays;
- Sundays; and
- state or federal holidays.\(^\text{12}\)

For instance, the last day of a grace period falls on a Saturday. Payment is not delinquent if it is received on or before the following Monday (Tuesday if Monday is a holiday).\(^\text{13}\)

Similarly, when the final day of the three-day notice falls on a holiday such as a Saturday, Sunday or other legal holiday, the three-day notice expires on the next business day.\(^\text{14}\)

Unlike the service of documents in a civil action, service of a three-day notice by mail following a failed attempt at personal service does not extend the three-day notice period an additional five days.\(^\text{15}\)

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12 CCP §§110, 121
13 CCP §113; Calif. Government Code §6706
14 Lamanna v. Vognar (1993) 17 CA4th Supp. 4; CCP §12a
To initiate the process for collecting delinquent rent from a tenant in possession the landlord serves the tenant with a three-day notice to pay rent or quit. The notice may be served on any day after the grace period expires without prior receipt of the rent.

Consider a landlord and tenant who enter into a rental agreement which sets the due date for rent on the first day of each month. The rental agreement also contains a **late charge provision** imposing an additional charge if rent payments are not received on or before the 10th of the month. A grace period is not mentioned in the rental agreement.

Each month, the tenant pays rent after the date for incurring a late charge. The landlord accepts the tenant’s late rental payments every month, but makes no written demand for payment of the late charges.

Finally, on receipt of yet another late payment, the landlord informs the tenant all future rent payments need to be received by the landlord prior to the date for incurring a late charge.

The next month, the late charge period stated in the rental agreement runs and rent has not been received. On the day the late charge is incurred, the 11th, the landlord serves the tenant with a three-day notice to pay rent or quit that includes a declaration of forfeiture provision. The tenant does not pay rent before the three-day notice expires. The landlord files a UD action.

As in the prior months, the tenant tenders the rent payment to the landlord after the late charge period has expired. However, unlike in prior months, the landlord refuses to accept the payment, claiming the tenant is now unlawfully occupying the premises.

Has the landlord established an unlawful detainer on expiration of the three-day notice?

No! The three-day notice is premature and useless. The tenant’s rent had not yet become delinquent. Rent is not delinquent until the grace period — including extensions authorized by the landlord’s conduct in accepting late payments — has run without receipt of rent.

When the rental agreement called for a late charge after a day other than the due date, a grace period was established, even though it was not explicitly identified as a “grace period.” Further, the landlord extends the grace period by consistently accepting rent payments after the grace period without demanding the late charge, a notice required to enforce collection of a late payment fee.

Thus, the tenant’s tender of rent was timely. It occurred after the written grace period but on or before the extended date set by the landlord’s conduct.
To reinstate and enforce the written grace period, a landlord first gives the tenant a 30-day notice to reinstate the terms for payment stated in the rental or lease agreement.

The 30-day notice states that all future rent payments becoming due following the expiration of the 30-day notice need to be received within the grace period. If future payments (due after the 30 day period) are not timely received, the landlord will demand the agreed-to late charge and serve a three-day notice on the tenant.

To be valid, the three-day notice to pay rent or quit served on a residential tenant needs to state the exact amount of money due and unpaid. Conversely, a nonresidential landlord may estimate the amount of money due and unpaid, when the exact amount cannot be accurately ascertained.

A residential tenant need not pay more than the amount due and unpaid to retain possessory rights under a rental or lease agreement.

However, if the amount stated in a three-day notice served on a residential tenant exceeds the amounts actually due and unpaid at the time of the UD trial, the notice is invalid.17

For both residential and nonresidential tenants, if the amount stated in the three-day notice is less than the actual amount due and unpaid, the tenant may pay the amount stated and avoid eviction. To collect any amounts omitted in a three-day notice, the landlord serves another three-day notice to pay the balance or quit.

A three-day notice served on a nonresidential tenant may include an estimate of the amounts due if:

- the notice states the amount due is an estimate; and
- the amount estimated is reasonable.18

Failure to indicate that an estimated amount due is an estimate renders the three-day notice invalid.

Further, if the landlord knows the exact amount due and states a different amount due as an “estimate” in the three-day notice, the notice is defective and the landlord will be unable to terminate the tenant’s right of possession.

An estimate of rent owed in a three-day notice is considered reasonable if:

- the actual amount owed is truly in question; and
- the delinquent amount demanded is neither 20% more or less than the amount determined due at the UD hearing.19

18 CCP §1161.1(a)
19 CCP §1161.1(e)
An estimate itemizing rent amounts not yet due, such as unbilled common area maintenance expenses (CAMs), is not considered reasonable. Amounts due in the future are not yet due or delinquent, and may not be included in an estimate of delinquent amounts due and unpaid.\textsuperscript{20}

Now consider a nonresidential tenant who takes possession of property on entering into a percentage lease agreement. [See \textit{first tuesday} Form 552-4]

The rent provisions in the lease agreement state:

- the rent is payable annually on the anniversary of the lease;
- the tenant is to provide the landlord with the amount of the tenant's gross sales proceeds; and
- rent is an amount equal to 20\% of the gross sales proceeds.

The tenant fails to furnish the landlord with the amount of the gross sales proceeds or make the annual rental payment. The landlord serves the tenant with a three-day notice to pay rent or quit. The notice states:

- the amount of rent which is due and unpaid in an amount equal to 20\% of the tenant’s gross sales proceeds; and
- only the tenant knows the amount of the sales proceeds.

The tenant does not pay the rent before the three-day notice expires. The landlord files a UD action. The tenant claims the three-day notice is invalid since the notice did not state the dollar amount of rent due.

Can the landlord evict the tenant even though the three-day notice did not state the dollar amount of the delinquent rent?

Yes! A nonresidential tenant cannot prevent the landlord from receiving rent or recovering possession by failing to provide the landlord with the means needed to determine the rental amount.

The purpose of a three-day notice is to give a tenant the opportunity to avoid forfeiture of the leasehold estate by paying the delinquent rent.\textsuperscript{21}

On receiving a three-day notice stating the rental amount due is an estimate, the nonresidential tenant may respond by tendering the amount of rent the tenant estimates is due.\textsuperscript{22}

If the amount the tenant estimates and tenders is equal or greater than the rent due, the tenant will retain the right of possession in a UD action. Likewise, when the amount estimated and tendered by the tenant is less than the amount actually due and was a reasonable estimate, the tenant retains possession by paying the additional amount and other sums awarded the landlord within five days after entry of the UD judgment.\textsuperscript{23}

\textsuperscript{20} WDT: \textit{Winchester v. Nilsson} (1994) 27 CA4th 516
\textsuperscript{21} \textit{Valov v. Tank} (1985) 168 CA3d 867
\textsuperscript{22} CCP §1161.1(a)
\textsuperscript{23} CCP §1161.1(a)
Subtenant evictions by the owner

For an owner to regain possession when the master tenant defaults and a subtenant occupies the premises, the three-day notice served on the master tenant needs to also name the subtenant as a tenant in default. Similarly, the notice is also served on the subtenant.

Serving a subtenant with a copy of the three-day notice that only names the master tenant will result in the subtenant retaining the right of possession.24 Conversely, an owner who wishes to evict a defaulting master tenant but retain the subtenant may do so. The owner is not required to serve the subtenant with a three-day notice when only the master tenant is being evicted.25

For example, an owner consents to a sublease agreement entered into by the master tenant and a subtenant which contains an attornment clause. If the master tenant defaults and fails to cure under a three-day notice to pay or quit containing a declaration of forfeiture provision, the master tenant forfeits their right of possession. Here, the owner may enforce the sublease by exercising the owner’s rights under the attornment clause in the sublease. [See Chapter 38]

Under the sublease’s attornment provision, the subtenant agrees to recognize the owner as landlord if the owner:

- elects to forfeit the master tenant’s leasehold; and
- recognizes the subtenant as the owner’s tenant.

However, a subtenant who takes possession of the premises after the master tenant has been served with a three-day notice will be evicted on the owner’s successful completion of a UD action.26

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25 Chinese Hospital Foundation Fund v. Patterson (1969) 1 CA3d 627
26 CCP §1164
A tenant defaults on their rental or lease agreement by failing to:

- pay rent and any other amounts due and called for in the rental or lease agreement; or
- perform nonmonetary obligations called for in the rental or lease agreement.

Rent needs to be delinquent before a three-day notice to pay or quit may be served. Rent becomes delinquent:

- the business day following the due date, unless a grace period is established in the rental or lease agreement; or
- the business day following the last calendar day of the grace period established in the rental or lease agreement.

Only a material breach allows the landlord to forfeit the tenant’s right of possession, such as the failure to pay rent or perform other significant obligations. Conversely, minor breaches alone do not justify a three-day notice to cure or quit.

After a landlord serves a tenant with a three-day notice to pay rent or quit, containing a declaration of forfeiture provision, the tenant is required to cure the breach in three calendar days to avoid forfeiture of the right of possession and eventual eviction.

For an owner to regain possession when the master tenant defaults and a subtenant occupies the premises, the three-day notice needs to also name and be served on the subtenant.
Notes:
Chapter 21: Three-day notices to quit for nonmonetary breaches

Three-day notices to quit for nonmonetary breaches

After reading this chapter, you will be able to:

• differentiate between a curable breach a tenant can resolve and an incurable breach a tenant cannot correct;
• use a three-day notice to pay or quit when a tenant fails to timely pay a money obligation;
• serve a three-day notice to perform or quit when the lease provision breached is not for rent or other money obligation but can be corrected by the tenant; and
• prepare a three-day notice to quit without an alternative when the tenant’s breach is incurable or statutory.

Assignment notice to quit
Curable breach nuisance
Monetary breach reasonable person test
Nonmonetary breach retaliatory eviction
Nonwaiver provision statutory breach
Notice to perform or quit waste

On a routine inspection of an apartment complex, the property manager observes a pet in one of the units. All the rental and lease agreements with tenants in the complex prohibit housing of a pet on the premises.

As a courtesy, the tenant is asked, both orally and by a personal note, to remove the pet. However, the tenant retains the pet.
To enforce the provision prohibiting pets in the tenant’s rental or lease agreement, the property manager prepares a three-day notice to perform or quit. The notice is served on the tenant. The notice gives the tenant an ultimatum — either remove the pet (the performance required) or vacate the unit within three days (the alternative performance). [See Form 576 accompanying this chapter]

The tenant fails to remove the pet from the premises and remains in the unit after the three-day notice expires.

Can the landlord file an unlawful detainer (UD) action to evict the tenant for failure to either remove the pet or vacate under the three-day notice?

Yes! On expiration of the three-day notice to perform or quit, the tenant may be evicted if one of the conditions has not been met. Here, the tenant breached the provision in their rental or lease agreement prohibiting the keeping of a pet on the premises. This type of breach, which can be remedied by the tenant’s action, is known as a curable breach.¹

However, if the tenant breaches a provision in their rental or lease agreement that the tenant is unable to perform within three days, the landlord or property manager may serve a three-day notice to quit the premises, permitting no alternative action. A breach which cannot be remedied by the tenant during the notice period is classified as an incurable breach.²

The three-day notice served on a tenant needs to be the correct type before an unlawful detainer, or holdover, of a premises can be established and the tenant evicted.

Depending on the nature and extent of the tenant’s breach, one of the following types of three-day notices may be served:

- a three-day notice to pay rent or quit [See Form 575 in Chapter 20];
- a three-day notice to perform or quit [See Form 576]; or
- a three-day notice to quit. [See Form 577 accompanying this chapter]

When a tenant’s breach is the failure to pay rent or other money obligation before it becomes delinquent, the tenant is served with a three-day notice to pay rent or quit. This type of breach is known as a monetary breach which is curable by paying money.

When the provision breached is not for rent or other money obligation, called a nonmonetary breach, and the breach can still be quickly corrected by the tenant, such as the pet situation in the opening scenario, the tenant is served with a three-day notice to perform or quit. [See Form 576]

¹ Calif. Code of Civil Procedure §1161(3)
² CCP §1161(3)
When a tenant is in default for a failure to pay rent as well as a curable nonmonetary breach, a three-day notice to perform or quit is used. The demand to pay rent is listed as an additional (monetary) breach to be cured under the notice to perform or quit.

A three-day notice to quit without an alternative requires the tenant to vacate. The notice to quit is served on a tenant when the tenant's breach is:

- a breach impossible to cure in three days; or
- a statutory breach.\(^4\)

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\(^3\) Matthew v. Digges (1920) 45 CA 561

\(^4\) CCP §1161(4)
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