Income Property Brokerage

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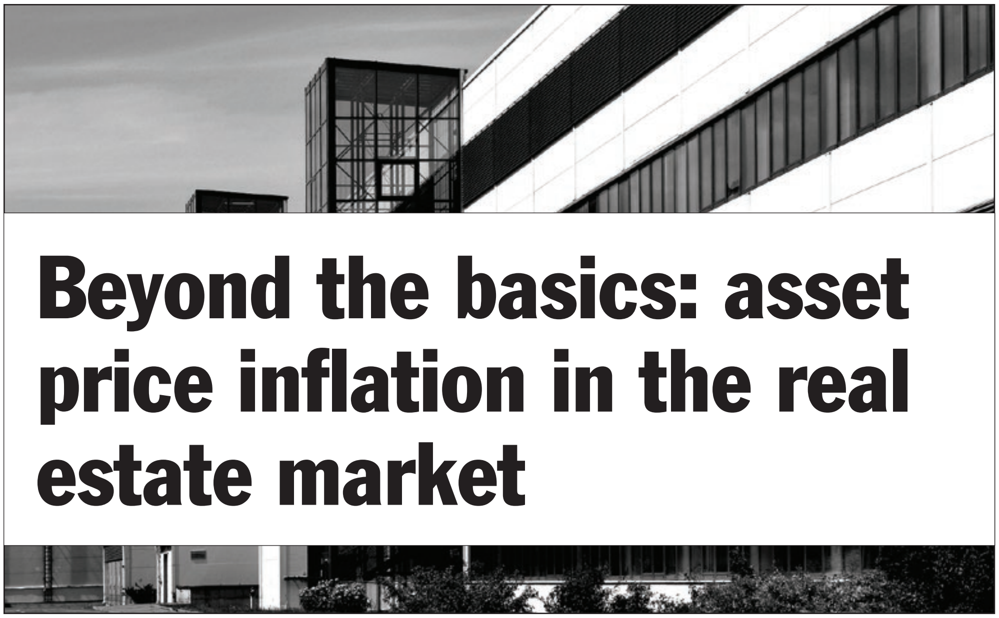

Chapter 1

Beyond the basics: asset price inflation in the real estate market

Learning Objectives

After reading this chapter, you will be able to:

- distinguish asset price inflation in the real estate market from consumer price inflation; and
- analyze and interpret the prevailing myths regarding real estate prices.

Key Terms

asset price inflation	**going negative**
commodity	**liquidity trap**
financial accelerator	**zero lower bound interest rate**

Asset inflation: where does real estate fit in?

Consider **asset inflation** in terms of various economic factors affecting the pricing in asset markets, such as stocks, bonds and real estate. The primary asset that concerns us in this material is **real estate.**

In contrast to the items priced to determine *consumer inflation*, real estate is not a **product** (i.e., a good or a service). It is an asset. The simple distinction here can be thought of in terms of consumption: a product (**commodity**) is, generally speaking, a consumable good requiring constant replacement. In contrast, an asset is reuseable, over and over again during a long term, subject to physical deterioration and obsolescence.

Once a *commodity* such as oil is purchased, it is consumed and needs to be replaced by further production of the commodity.

Alternatively, a tangible or intangible asset is considered property. This property is held by an owner who may expect future economic opportunities

asset price inflation
A rise in the price of assets, such as stocks, bonds and real estate.

commodity
A marketable good or service.

during ownership, i.e., by using it themselves, leasing it to others, selling or trading it. The owner does not consume or deplete it. It does not therefore need to be replaced when used, as is the case with commodities.

The *Consumer Price Index (CPI)* does not measure *asset inflation*. Asset prices behave quite differently and independently from consumer price movement.

The amount of money in circulation controls

Although inflation behaves differently between assets and consumer goods, the two are intimately related. Why? They are both directly affected by the amount of money in circulation. At times, one more than the other, as we are seeing with the asset inflation in quickly rising home prices while at the same time little to no consumer inflation exists in the recovery as it currently stands.

If the money supply in circulation increases to the point it causes consumer price inflation, the purchasing power of the dollar has decreased. In tandem, the level of real incomes decreases. As income loses purchasing power, workers are provoked to demand wage increases to at least keep up with inflation, if they are to continue their present style of living.

Consider consumer inflation in terms of increases in rent, amounts paid for leasing the use of a home or commercial space; a consumable event and an income and expense sheet expenditure item. The right to possession granted to a tenant by leasing is not an asset, and thus it is not a balance sheet item for the tenant. On the other hand, ownership of a home or commercial property is a *dollar-denominated asset* bought and sold, and listed on the owner's balance sheet.

At a fundamental level, asset price inflation is directly affected by the money supply. However, one needs to take it further to get a deeper understanding of this interplay. One needs to consider the idea of **supply** and **demand** to fully understand asset price inflation in the real estate market.

Consumer price inflation versus asset price inflation

Perhaps the most important factor affecting real estate price inflation is the relationship between *supply* (marketable inventory on the multiple listing service (MLS)) and *demand* (ready buyers) in the real estate market.

As user-demand for real estate ownership outpaces the MLS supply of property for sale, the market environment experiences a *scarcity* of supply reflected in reduced inventory for sale. As a result, real estate prices increase (or *inflate*). This pricing occurs whether or not there is an excess in the supply of money, but the excess supply will accelerate the rate of asset inflation until of course the excess supply is removed by an increase in interest rates.

Just as with consumer price inflation, the *purchasing power* of the real estate (asset) buyer diminishes since there are too many dollars being allocated to chasing a fixed quantity of assets (property). Thus, the buyer's dollar will

Figure 1

Consumer price inflation versus asset price inflation

Consumer price inflation (CPI) is best understood as a fluctuation in the available money supply (the basic monetarist view).

Asset inflation necessarily includes issues of supply and demand as well as interest rates, especially in terms of its relationship to rates on mortgages taken out to purchase property.

now purchase a smaller percentage of the same home as it would have in the period prior to home price inflation. Thus, more dollars are required to buy the same property than needed at an earlier date.

Editor's note — Buyer purchasing power is also determined by interest rates and buyer incomes.

Real estate price inflation versus appreciation

A word of caution: real estate price inflation is often confused with real estate *asset appreciation* for lack of awareness of their obvious distinctions. They are mutually exclusive principals, but both relate to an increase in property value over the price paid for the property. When discussing real estate prices affected by *monetary policy*, one is referring solely to the portion of price increases resulting from asset inflation, as we are doing here.

Real estate appreciation is just what it is called: an increase in price driven by the personal appreciation that buyers and sellers have for a particular parcel of real estate. Property price appreciation is primarily driven by an increase in population density around the location of the property and the income of that population — not the intrinsic value of a parcel of real estate or by consumer price inflation figures.

In math terms, the price attributable to appreciation is the increase in value of a property exceeding the rate of inflation brought on by annual lost purchasing power of the dollar — consumer inflation, precisely.

Thus, "appreciation" is a qualitative term that reflects the human perception of a property's value. This perception is then reflected in pricing when this perception increases demand for the location, or simply for the specific property, beyond the price dictated by the rate of consumer inflation.

The prevailing lesson taught by the implosion of the Millennium Bubble is that price and value are not well correlated. Most of all, the recurring notion that real estate perpetually "appreciates" was destroyed by the Great Recession, or at least for a generation or so. These cardinal myths floating in the real estate market need to be banished from the realm of rational discussions concerning real estate price increases.

Mean pricing ideas are also here involved as properly instructive of the future. The **mean price trendline** of real estate reflects the consumer inflation rate and income levels (and general population increases) and a further increase in value brought on by the location's appreciation. Thus, real estate pricing over the full term of a business cycle, not periodic or permanent property value increases, include the rate of consumer inflation and the rate of any increased appreciation due to changing demographics of the location.

Interest rates and real estate price inflation

Although supply and demand in the real estate market are affected by a multitude of factors, the demand for real estate as we have known it since the Great Depression is fundamentally encouraged by the availability of mortgage funds from lenders. In a word, real estate acquisitions are *leveraged* in over 80% of transactions since very few buyers-occupants have cash savings sufficient to pay more than a small fraction of the seller's asking price.

As most real estate acquired to be held for the long term is not purchased with cash, the primary source for satisfying property demand comes from lender purchase-assist financing. The availability and abundance of purchase-assist financing is dictated by interest rates, influenced by the general creditworthiness of the borrower and the appraised value of the collateral.

Lenders hold hostage the real estate market's primary means for facilitating the purchase of property. Thus, they are mostly in control of real estate (asset) price inflation. However, lenders outsource and rely exclusively on appraisers and credit agencies for two critical decisions:

- one concerning the qualification of the property; and
- the other the borrower's propensity to repay debt.

During the 2000s, this reliance proved defective, and will likely return to haunt lenders during the next real estate boom as regulation has done little to correct either.

However, this is only part of the picture. The Federal Reserve (the Fed) plays an important role here as well by setting interest rates.

The financial accelerator effect

financial accelerator
The cyclical phenomenon of increasingly larger mortgage amounts based on increasingly inflated prices of the same collateral.

It was the Fed's failure to control interest rates during the 2000s that produced the **financial accelerator effect** which led to the crash of both real estate prices and Wall Street markets. The *financial accelerator effect* occurs once mortgage lenders begin realizing greater profits due to asset price inflation in the real estate market.

As prices went up, lenders earned greater returns on their capital regardless of the interest rate. They were able to periodically lend ever greater principal amounts on new mortgages as prices increased — all based on the same property as collateral.

Further, each lender wanted greater profits as a matter of maintaining their competitive advantage since they had to attract depositors by paying ever greater returns lest they lose them to other lenders. Emboldened by the notion that the collateral they were holding was "worth" more than the mortgage amount (a money illusion), lenders made more and larger mortgages to ever less qualified borrowers collateralized by the same or comparable property. The result was massively increased homeownership among those who were tenants not qualified to be homeowners.

This was the prelude to the vicious market cycle the Fed was supposed to regulate out of existence but failed to do. Congressional de-regulation since 1980 set the Fed up for failure during the decade of 2000, and the Fed fell into the trap by constantly lowering interest rates to improve economic conditions, called the **Greenspan Put** at the time. The result was the financial crisis of 2007 when interest rates hit the zero lower-bound rate when a negative rate was then needed to help the economy when fiscal policy was unwilling to invest in sufficient projects to keep the population employed.

The market today

Consider the landscape of the real estate market going into 2020. Prices are commonly perceived to be high by end users of real estate, having increased rapidly during 2013 through late-2014 due primarily to excessive speculator activity and more gradually as they decelerated in 2015-2016.

In order to create some stability for the real estate market and stimulate mortgage lending to end users acquiring real estate, the Fed has exercised its right to keep short-term interest rates at essentially zero, ending its pumping of cash into the banking system in late-2014 without first **going negative** as part of their monetary policy. The Fed initially increased short-term interest rates in December 2015, though FRM rates are unlikely to rise until bond rates eventually rise.

> **going negative**
> The Federal Reserve's charging of interest on the excess reserves of lenders, stimulating lending activity.

The Fed's hope was that low nominal interest rates (combined with the Fed's past three rounds of pumping cash into the financial system – quantitative easing) may generally encourage lenders to make more loans at cheaper rates to homebuyers (and businesses). More lending for more commerce and real estate sales is preferable to bank's holding massive amounts of reserves un-lent, which is still the case today as during the past seven years.

So the thinking goes: flush the banks with cheap cash so they will then redistribute the cash via purchase-assist financing to homebuyers. This will make willing those ready and able homebuyers by passing on low interest rate to them – lending at a rate equal to the rate for risk-free 10-Year Treasuries and the historical 1.5% profit margin.

Has the Fed's plan worked? We think not (though it likely did not worsen the housing recovery) — and there is a generally unacknowledged reason for this: a lack of *buyer-occupant demand*, or no matter how cheap mortgage money becomes the public will not further borrow and buy.

The zero lower bound and liquidity trap

zero lower bound interest rates
Economic conditions characterized by a very low nominal interest rate. As the interest rate is at or near zero, the Federal Reserve (The Fed) cannot lower it further to stimulate the economy without going negative.

The reason why this plan has not worked can be summed-up with two financial crisis concepts:

- **zero lower bound interest rates**; and
- **the liquidity trap**.

The scenario described above regarding the current plan for asset inflation is one piece of the *zero lower bound interest* rate puzzle. As lowering the interest rate is the Fed's primary means for stimulating lending and thus home sales, there needs to be an interest rate baseline which is deemed effective to stir up buyer demand.

However, once rates have reached zero as they did back in 2009, remaining there through December 2015, the Fed is rendered impotent to move the economy, since it is unwilling to lower the rate sufficient to excite lenders and borrowers by the Fed going negative on interest rates. It may not (politically in the U.S.) lower rates beyond the zero lower bound as is needed to spark bankers and buyers of homes into action. (Europe's banks have overcome this mental barrier and gone negative to encourage borrowing and spending.)

By the Fed going negative on their lending rates (to banks, not the public or homebuyers), the Fed would literally be paying banks to accept cash advances from the Fed. Remember, the Fed has an infinite supply of money, is always repaid, and can never become insolvent.

The aftermath of zero-bounded rates

liquidity trap
A condition in which injections of cash into the banking system by the Federal Reserve fail to stimulate lending and economic growth. In the instance of California's current crisis, cheap cash is sitting in lenders' reserves and not being lent to prospective buyers.

In the aftermath of zero-bounded rates, inflation is still below the Fed's target rate of 2% and no expectation in the long-term bond market that it will rise for a decade or so, the mortgage lending market remains inherently sluggish — the *liquidity trap*. The likely reason is the lack of sufficient consumer inflation to encourage spending. Banks are swimming in basically free cash facilitated by the Fed. They are in a state of extreme liquidity since they have tons of cash that they have deposited with the Fed and are not investing in banker's assets, such as mortgages.

Yet, credit — cash — is available, but only to the most qualified buyers. Most others with a solid job in this recovery are deemed uncreditworthy due to prior unemployment, foreclosure, short sale or bankruptcy and present low wages.

This is the liquidity trap Californians are snared by. While cheap cash is in the bank's coffers, it remains trapped out of reach of prospective buyers. Thus, asset price *inflation*, much less one's *appreciation* of California as the place to own real estate, has gone nowhere with one hugely influential exception – **speculator** acquisitions for profit on a flip, as short-term absentee owners with cash to burn.

Consumer inflation is the name of this game (for now)

This brings us back full circle to consumer price inflation and the *CPI*.

Until banks open the floodgates of liquidity, necessary asset price inflation in the real estate market will only be a reality once the economy as a whole — jobs and wages — picks up.

What will this look like?

- Near-to-**full-employment** levels of 2007 (the number of job lost to the Great Recession were recovered by mid-2014, but employment numbers won't catch up with population growth and be reflected in wage increases until about 2019);
- Increasing **gross domestic product (GDP)** exceeding the rate of inflation and California's 1% annual population growth; and
- The slow but steady process of making those credit-crunched buyers **creditworthy** again (as the Federal Housing Administration (FHA) has decided to do, and credit agencies if not banks will soon follow the government's lead).

This is a description of a *virtuous market cycle*. Once the ball of the California economy starts rolling again, the market will be released from the liquidity trap and those zero bound rates may start working.

However, the economy has now broken loose from the bondage of the zero lower bound rates with the Fed movement on short-term rates at the end of 2015. Escaping zero rates heralds in a future of continually rising interest rates with a time horizon of two or three decades, except for dips during recessionary periods.

Once mortgages rates rise consistently into the 4% range, real estate investor *capitalization rates* will rise to meet that challenge. Bond prices, stocks and real estate values will drop in reciprocal response.

Hedge against inflation

Going forward, expect real estate prices to reliably increase at the annual rate of consumer inflation, plus some rate for appreciation due to population build up and wage increases, for the foreseeable future (3% per annum). Any annual rise actually experienced in market prices beyond 3% (like the tax-stimulus price rise in 2009 and the speculator driven price rise of 2013-2014) is unsustainable and unsupported by user demand and will eventually return to the mean price line.

Five to seven years of ownership on future acquisitions will give an owner the ability to sell and recover their cash down payment and principal amortization as net sales proceeds. Those lucky to live in a location which experiences excessive population and income growth will take profits due to regional appreciation.

Thus, right now California real estate, regardless of type, is essentially a **hedge** against consumer inflation for those in ownership.

Chapter 1 Summary

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It was the Fed's failure to control interest rates during the 2000s that produced the financial accelerator effect which led to the crash of both real estate prices and Wall Street markets. The financial accelerator effect occurs once mortgage lenders begin realizing greater profits due to asset price inflation in the real estate market.

In the aftermath of zero-bounded rates, inflation is still below the Fed's target rate of 2% and no expectation in the long-term bond market that it will rise for a decade or so, the mortgage lending market remains inherently sluggish — the liquidity trap. The likely reason is the lack of sufficient consumer inflation to encourage spending. Banks are swimming in basically free cash facilitated by the Fed. They are in a state of extreme liquidity since they have tons of cash that they have deposited with the Fed and are not investing in banker's assets, such as mortgages.

Chapter 1 Key Terms

Chapter 2

A realty black hole — negative equity

Learning Objectives

After reading this chapter, you will be able to:

- understand the psychological underpinning of the recent boom and bust in California; and
- identify key players in the final phase of a housing boom.

Key Terms

hit-and-run buyers **momentum traders**

Belief in ever-rising prices brings implosion

Between 2002 and 2005, the **Millennium Boom** ignited and left a mushroom cloud over the housing market. This boom ultimately vaporized trillions of dollars of personal wealth across the nation. How did this situation come about?

After the events of September 11, 2001, the *Federal Reserve (the Fed)* failed to maintain the short-term interest rates they had recently increased. The purpose of the series of increases in rates was to correct the 1999-2000 excessive ballooning of prices in the real estate and other asset markets.

Thus, with prematurely lowered market rates post 9/11, accompanied by reduced tax rates and increased government and private spending, the Fed set the stage for the 2008 recession's economic devastation of asset values, mortgage deregulation nearly fully in place at the time. Both real estate and stocks were affected. Asset price inflation was the goal, and the Fed got it in spades.

The devastated real estate prices brought on during the 2008 recession were also largely wrought with what became debt-leveraged erstwhile speculators. Lured by the false impression that prices would continually rise, speculators succumbed to the momentum of the crowd.

Perceived good time to buy

In 2002 and 2003, the first phase of the *Millennium Boom*, a large and growing percentage of U.S. households perceived it was an economically prudent time to purchase real estate. The administration's policy to push up homeownership rates by American Dream propaganda and Freddie Mac was heavily at work. Prices had stabilized since 2000, but sales volume was picking up to bring on home price inflation.

72% of homebuyers cited favorable credit conditions of low interest rates as the cause for their enthusiasm. By mid-2003, when prices had risen beyond consumer inflation rates, 85.2% of the population felt it was a good time to purchase a house. This occurred approximately two years before the peak of the sales volume boom, producing a bandwagon effect. This was precisely what government agencies sought, and got.

This enthusiasm, coupled with an overabundance of very cheap money supplied by the Fed, caused asset prices to naturally rise more rapidly through the second phase of the boom from 2004 into early 2006. Soon, the monthly upward resetting of prices by brokers dampened most households' enthusiasm for homeownership. Thus, occupancy began to rise and vacancies dropped in residential rentals.

Instead of sales in the housing market cooling as potential homeowners withdrew, a relatively small but wealthy portion of the population rushed into home purchases. Their quest was to profit solely from the perceived continued rise in home prices, no occupancy intended. Their assumption was that future prices would continue to increase. They expected a steep trajectory similar to that established during the first phase of the boom between 2002 and 2003.

Speculators lead the way to disaster

As reported by the *Federal Reserve Bank of Minneapolis (FRBM)*, the housing price bubble was inflated to extravagant heights during the second phase of the Millennium Boom. This was due to the widespread belief that prices would perpetually escalate. The belief was contagious, and spread among speculators with epidemic-like swiftness and voracity.[1]

In an average year, 9.2% of U.S. households are optimistic about the future trends of home prices. This means they believe it is a good time to buy a home since they see prices rising in the future. Thus, in tandem with the sudden increase in home prices in 2004 during the second phase of the boom cycle, a larger percentage of the population became optimistic about future home prices rising as a way to create wealth.

By the middle of 2005, 20.2% of households shared this belief. They became themselves **momentum traders**. They too became convinced that real estate prices could not fall below peak levels, as they previously did in 1991 and 2001.

momentum traders
Buyers relying on the emotion of frenzied market participants, rather than property price inflation, to profit from buying and reselling property.

1 "Momentum Traders in the Housing Market: Survey Evidence and a Search Model," by Monika Piazzesi

When this psychology was paired with unprecedented short-term property price inflation and low consumer inflation, the result was a disastrous spread between market prices and the mean price trend line. Real estate prices were pushed further upwards in a self-enclosing circle.

Prices rose as more optimistic speculators made purchases, temporarily withdrawing property from the market, reducing inventory for buyer-occupants. The result was increased prices fueled by the optimism of even greater numbers of speculators entering the fray to make even more purchases at ever greater prices, a fool's game.

Hit-and-run buyers

Speculators accounted for 25% of real estate buyers in 2014 (more when including trustee sale acquisitions). They do not enter the real estate game with the intent of procuring a long-term source of earnings, as do investors in income property or land. Neither do they intend to occupy or otherwise use the properties they purchase.

They are **hit-and-run buyers** who perpetually flip their purchases. Property traders, much like day traders. All the while, they are conscious that the financial wave they are riding will eventually crest. But remember, real estate is a collectible representing a "store" of wealth, a producer of annual income and a hedge against inflation. For speculators, however, cash is the collectible.

hit-and-run buyers
Flippers who purchase real estate with the intent to quickly resell it at a profit produced by market momentum, not fundamentals.

Of course, speculators cannot tell precisely when the wave will lose momentum and crash in the sand. Thus, those remaining are often forced to take a loss when a hot market turns cold. They are prevented from flipping those last purchases at a profit.

Speculators' numbers increased between 2004 and 2005. However, they only accounted for approximately 3% of the total population. The majority of households believed housing prices had climbed erratically high. They opted to wait out the maelstrom, making the rational decision to remain tenants. Rental costs tend to be at or below one-half the rate required to own equivalent shelter under boom-time prices.

Real estate sandwichers

Most people after 2004 acquired a negative impression about the real estate market, based on the fundamentals of rental value. Others satisfied themselves with home improvements, content to stay put in their current homes during the second half of the boom. Thus, a large and increasing swath of the population was not involved in real estate activities. The ever-important turnover level declined, reducing sales volume, then prices.

With buyer-occupants leaving the market speculators became an even larger share of the transactions closed. Their market involvement effectively pulled housing, new and used, temporarily off the market and made property appear scarce. However, much of this property was to return later as *real estate owned (REO)* resale property after the 2008 crash.

In these transactions, optimistic speculators pushed home prices up by paying prices consistent with their starry perception of inflated future values. They believed any **carrying costs** expended would invariably be dwarfed by future gains. In this way speculators multiplied in tandem with the price increases.

They doubled up on acquisitions and became a powerfully influence on prices in the housing market. Even though they made up a comparatively small portion of the overall population, their effect on the market was significant.

Regular households become speculators

But what caused this paradigm shift that turned regular households into speculators? What caused the speculators to collectively adopt the irrational view that this housing boom was incapable of deflating like all previous real estate booms did — 1974, 1981 and 1991?

Perhaps real estate agents, the *gatekeepers* of the real estate industry, are partially to blame for propagating this frenzy. Brokers gained knowledge through their professional experience in the early '80s and '90s.

Yet, they failed to apply this knowledge to question the prevailing wisdom of speculators. Maybe they just did not understand the pervasive adverse impact of speculators, as do tract builders who abhor them, or did not care.

Like the population at large, many agents became optimistic about future home prices when prices spiked during the second phase of the Millennium Boom. In 2003, 10% of agents believed home prices would increase further. In 2005, during the second phase of the boom, this amount doubled to 20% (but then, so did the amounts of closings and fees).

Licensees buy into the myth

Not surprisingly, the population of licensed agents spiked as if on steroids. To meet the long-term, public demand for licensed real estate services, California's needs less than 1,200 new licensees per month. Yet, the number of new licensees in California swelled to 5,000 per month during the peak of the Millennium Boom. This continued for nearly three years through September of 2007 — nearly two years after the demise of flipping by speculators for lack of market momentum.

Then, new licensees plummeted, bottoming at 1,000 new licensees per month in 2012. This trend reversed direction following the most recent speculator over-activity. In 2016, 1,800 new agent licenses on average were granted per month. The short-term, speculator-induced boom in prices lured in new agents, directly related to mismatched fee perceptions and the realities of the real estate market.

Rising prices entice new agents while simultaneously weakening sales volume; fewer fees in turn drive expiring licensees away. The direct correlation between sales volume and agent licensing shows licensing movement changes 6-12 months after a consistent directional change in home sales volume. Year-over-year home sales volume dropped every month beginning October 2015 through late-2016.

The current influx of fresh agents will end the moment stories emerge in the media about falling prices and increasing foreclosure rates, a near certainty as the price run up experienced since 2012 deflates.

Chapter 2 Summary

The devastated real estate prices brought on during the 2008 recession were also largely wrought with what became debt-leveraged erstwhile speculators. Lured by the false impression that prices would continually rise, speculators succumbed to the momentum of the crowd.

Most people after 2004 acquired a negative impression about the real estate market, based on the fundamentals of rental value. Others satisfied themselves with home improvements, content to stay put in their current homes during the second half of the boom. Thus, a large and increasing swath of the population was not involved in real estate activities. The ever-important turnover level declined, reducing sales volume, then prices.

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Chapter 2 Key Terms

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Chapter 3

Rentiers and debtors: why can't they get along?

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between society's rentier class and debtor class;
- identify the political ideology of the rentier class; and
- specify the beneficiaries of current fiscal and monetary policy.

Key Terms

John Maynard Keynes

trickle-down economics

rentier

The world of passive entitlement

Consider a large and powerful Wall Street investment bank. In the years leading up to the 2008 financial crisis, the bank creates $100 billion worth of tranche-complex and high-risk **mortgage-backed bond (MBB)** investments. Designed for public consumption by investors, MBBs are comprised of:

- *residential mortgage-backed securities (RMBS)*;
- *collateralized debt obligation (CDO) securities*; and
- *credit default swaps (CDS)*.

The bank sells most of the bonds to unsuspecting investors, without disclosing the high risk of loss that accompanies them. Then comes the *financial crisis,* causing homeowners to lose jobs and homes to drop 50% in value. These conditions bring on an unsettling number of mortgage defaults.

To maintain its profits and the fortunes of its MBB investors, the banker advocates public policies such as:

- low inflation;
- financial bailouts and subsidies;
- expansive monetary policies (including *quantitative easing* and depressed interest rates); and
- fiscal policies socializing/funding private banking losses.

Prolonged suffering

These policies, however, prolong the suffering of the unemployed and mortgaged homeowners while allowing the bankers to prosper. This is, of course, the well-known story of *Goldman Sachs*; but, almost every other major Wall Street brokerage and every major bank (and, therefore, every major mortgage lender) has a similar tale to tell.

Mortgage borrowers during the *Millennium Boom* were misled. Bond market investors were defrauded. There were illegal foreclosures, retaliatory credit scorings, and insider bets against housing mortgage values. The lawsuits are now reported cases of facts and rules for all to know.

It ought to come as no surprise that borrowers, who make up the vast preponderance of the U.S. population — the 99% — continue to suffer a reduced standard of living. The plight is due to the long stretch of unemployment and slow income increases since the recovery took shape. At the same time, the Big Banks which were partially responsible for the recession continue to succeed and thrive economically.

rentier
The class of earners whose income is earned passively, generated from owned tangible and intangible assets rather than through their labor.

As businesses, banks work in their own best interest, and their continued financial success indicates their business and political strategies are effective. Mortgaged homeowners had no voice until 2011 when the federal government created the **Consumer Financial Protection Bureau (CFPB)** as a first-of-its-type agency designed solely to protect borrowers. Transparency at the window for mortgage applications, processing, funding and remediation is now firmly in place, functioning and quickly became customary.

Different laws for different social classes

In a June 2011 report on *creditslips.org*, the author draws the distinction between:

- the **rentier** class, made up of those who lend money or let real estate; and
- the **debtor** class, comprising those who borrow or rent.

The *rentiers* exist *in opposition* to renters; the latter pay, and the former collect.

Rentiers, the report points out, are largely governed by the laws of large for-profit corporations. This entitles them to participate in behavior forbidden to individual members of the general public.

At the bottom of the bankers' advantage is a fundamental contradiction. Banks are given access to money at extremely cheap rates by their unique ability to borrow from the Federal Reserve (the Fed), the initial source of all U.S. currency.

To stimulate spending in this recovery, the Fed consistently lent money to banks at essentially zero percent interest rates, until December 2015 when the rate increased for the first time since 2009. Still, the Fed's target short-term lending rate is still a very low 0.25%-0.5% as of late-2016. In return, the banks are expected (though not required) to increase their own lending to private borrowers.

It's just corporate business strategy

Meanwhile, insolvent bankers are able to escape their excess debts by passing them on to the *Federal Deposit Insurance Commission (FDIC).* In extreme circumstances, they receive massive government bailouts (recapitalization) funded by the U.S. Treasury, as occurred in 2008 under the **Troubled Asset Relief Program (TARP).**

When banks escape financial obligations they are unable to pay due to their own mistaken calculations and harmful behavior, it is considered a legitimate corporate business strategy. In contrast, mortgage-holding homeowners are left to repay their mortgage debt as bankers steadfastly resist any congressional attempts to make it easier for homeowners to escape (in bankruptcy) even the most egregious amounts of excess debt.

Homeowners can push for the same right as banks through *cramdowns* orchestrated in bankruptcy court or by walking away from an **underwater mortgage.** This decision to escape debt is at best a lender and government labeled moral failure; at worst a legal impossibility (although not in California, an *anti-deficiency* state).

As a result of bifurcated debt-resolution rules, the nation is divided into two separate and adverse *economic classes*, each of which ironically depends upon the other. **Class warfare** seems to be the inevitable result of this dichotomy, as the economy has not always been as clearly divided as it now is.

In reality, it is not at all difficult to envision a society in which the interests of *rentiers* and *borrowers* are far more closely aligned. To understand how this is possible, a clearer definition of the term "rentier" is required.

Who are the rentiers?

Rather than referring to a "lender class," it might be useful to think of the rentiers as all those who receive fixed income yielded from tangible and intangible assets they own, not their personal efforts. While most of our population derives its income from the direct production or sale of a good or service they provide, rentiers profit by *passively earning income* generated by their possessions

For example, a mortgage held by a hard money lender and an apartment/commercial property held by a property investor (as in portfolio and passive income tax category investments) make the owner a rentier.

On the obverse side of the coin are business people, professionals and employees, who are active and earn money for their efforts. Also on this side are speculators (day traders/flippers) who buy and sell property or other assets and profit on the resale. They need to go to work each day if they are to have an income flow, since they have not built up wealth which produces income independent of their efforts.

Lords and serfs we have again become

It is not wholly misguided to think of the rentier class as the *lords* to a set of modern day *serfs*. The serfs work to gain income to pay for their needs. Their standard of living is set by the success of their efforts alone. They depend however upon their lord for resources, especially shelter. Of course, their labors also go to enrich the moneyed property owners who provide land and protection for the serfs.

trickle-down economics
The economic theory suggesting that an increase in the strength of the wealthy leads to an increase in the well-being of lower classes.

The arrangement is sometimes necessary for the serf — they need a safe place to grow their crop — but is consistently more lucrative for the lord. Theories such as **trickle-down economics** suggest that an increase in the strength of the lord will lead to an increase in the serf's well-being. But evidence repeatedly shows this is not the case.

The political success of the rentier regime in the current post-recession, financial crisis economy is indicative of an overall reversal in economic policy from the *Keynesian* economics in force at the close of World War II (WWII) (the biggest fiscal stimulus ever). Those policies lead to 30 years of the greatest expansion the U.S. has ever experienced.

John Maynard Keynes
An economist well-known for his stance that governments need to smooth out the effects of expansion and contraction in the business cycle through fiscal and monetary policy.

In that period of constantly rising interest rates needed to keep growth in check, the dominant group (the U.S. and allied forces) considered demanding overwhelming repayments from the defeated nation of Germany. However, they instead listened to the advice of **John Maynard Keynes**, from Britain. It was his (and Roosevelt's) Bretton Woods monetary system that emphasized economic recovery for the winners and losers both. We grow together from the ruins.

Rather than the victors paying their vast war debt with money demanded from the defeated (a WW1 situation which did not work out well), the Fed tightly regulated the financial markets to reduce speculation and dramatically lower interest rates. The results were economically beneficial for both the defeated and the victorious: a monetary *Marshall Plan*.

Conflicting philosophies

In an ideal government, the conflicting demands of separate political contingencies — the few rentiers and the many debtors — will be balanced to the benefit of the largest contingency.

The **austerity measures** that are most beneficial to rentiers are unacceptable to the much larger group of debtors, and thus one might include the government. That debtor group is made up especially of homeowners, who benefit from economic stimulus and tighter regulation of lenders by government. The debtors make up most of the working population. They actively create items, provide services for sale and disproportionately pay a variety of taxes.

Thus, government agencies have an additional incentive to ensure the continued wellbeing of the populous debtor class. However, political differences about fiscal stimulus and austerity often slow or halt economic growth for the debtor class.

Entrenched rentier dominance

Nobel laureate *Paul Krugman is* one persistent critic of the extent rentier dominance has taken hold in contemporary U.S. and international politics. Krugman and other salt-water economists submit that establishment economic policy is misguided and even harmful by the tenets of Keynesian economics. Present policy is predisposed to ensure that in times of economic distress debts of individuals are enforced rather than either forgiven or artificially reduced by temporarily high inflation.

After all, the increased purchasing of goods and services and the resale of homes is necessary for the economy to recover. As seen in the long six years it took to reach a tentative recovery in California, when a vast swathe of the population's income is diverted to repay principal and interest on underwater mortgages, the economy suffers.

This is not to say a secret cabal of rentiers controls U.S. politics. However, the ideology of the rentiers has ceased to be limited to ideology held by a *wealthy elite*. Instead, it has insinuated itself into mainstream political thought like an invasive species conquering the weakest.

Wall Street versus main street

As a result, the rentiers as a class continue to be among the very few to reliably achieve *continued financial success* in this period of global wage stagnation. Their stocks, bonds and rental properties have fully re-inflated and in some instances surpassed their pre-recession levels (but not yet all homes).

Thus, rentier-friendly policies unavoidably pit Wall Street bankers against the needs of Main Street individuals for jobs and housing and assistance until jobs are available at full labor participation rates sufficient to support the national standard of living.

The inadvertent result of current world policy, which sets the interests of debtors against those of creditors, is a different form of conflict: **class warfare**.

Opposing views focus attention

Complicating the issue is a report by *The Economist,* which counters Krugman's description of the current policy situation.

It argues that Krugman's advocated policies of higher government spending, through programs like an expansion of the Fed's bond purchases (called **quantitative easing or QE**), are actually no more likely to help debtors than lenders. That is, the distinction between the two from a monetary policy perspective is *illusory*.

The Economist claims "sound money" and "balanced budgets" in times of financial crisis are the defining elements of historical rentier dominance. It supports this claim by reference to the presidency of William McKinley, which was based on maintaining the gold standard and low inflation (Britain did the same after WWI).

The Economist contrasts that period of rentier dominance with the Administration following the recession: "two years of quantitative easing, huge budget deficits and negative real rates. 19th century central bankers would regard this era with anathema."

The effect of quantitative easing

Government funded projects are advocated as necessary Keynesian stimulus to repair the economy by elevating it to a level of activity that will be self-sustaining when the stimulus ends. Federal stimulus projects enacted during the Great Recession recovery did very little to improve the long-term status of homeowners threatened by foreclosure.

In contrast, excess speculator liquidity fueled by *QE* Fed programs has done much more to reflate home prices. The recent rounds QE of had the direct, immediate and pronounced effect of bolstering share and bond prices, commodities markets and income producing real estate, but not homes (except for speculation's effect in the low-tier price range).

The sole present beneficiaries are Wall Street bankers and executives — the rentiers. Troubled Main Street homeowners with negative equities and few prospects for more jobs and higher wages soon did not benefit.

Essentially, these projects were neither properly directed to assist mortgaged homeowners nor sufficiently extensive to make an immediate, measurable difference.

The policies most valuable to all of society's participants are those which lead to *debt forgiveness*, even at the rentiers' immediate expense. These, however, we are unlikely to see.

Foremost among these options is temporarily increased inflation. The Fed easily manages inflation, as was seen by Fed Chairman Volcker's 1980s ending of rampant inflation which the prior Fed management permitted. In contrast, deflation is very difficult to reverse unlike inflation.

There is also the much discussed principal cramdown of mortgage debt to the value of the home it encumbers. But addressing this calls for Congress to reinstate 2005 homeowner bankruptcy rights now only available to property investors – that rentier class distinction again.

A harmful artificial distinction

Debtors and rentiers will always be naturally troubled by **conflicting interests**. The current state of conflicting policies is the result of a peculiar set of regulations that apply to banks. Economic blogger Steve Waldman points out that "banks, after all, are not only creditors. They are also the economy's biggest debtors." All deposits they hold are amounts they alone owe their depositors, although guaranteed by the U.S. government. As such, banks are merely a conduit for flow of the nation's cash.

In a *rational world*, without the assurance (if not implicit guarantee) of government bailouts, bankers will be as concerned about their own risk of insolvency and bankruptcy as are the homeowners whose mortgage debt they hold.

The advocated solution is a removal of policies which grant *artificial security* against loss to bankers — the socialization of business losses — while denying similar security to homeowners. Such policies are harmful since they include bizarre accounting regulations and the implied guarantee of bailouts behind the "too-big-to-fail" mentality. The current overly generous guarantee of newly originated consumer mortgages by the government via the Frannies/FHA/VA falls into this mentality.

These fiscal policies make it easy for banks to obscure their troubled assets from investors (as well as the lack of regulation that makes abuses, like Goldman-Sachs', possible), which of course they do. That is, rentiers — like homeowners — need to know they are at risk of foreclosure by the FDIC if their debts (held by depositors) are not able to be repaid from the value of the assets that secure them as collateral.

Troubled assets obscured

It is important to remain aware of which class — rentiers or homeowners — stands to benefit from future changes in *fiscal* or *monetary policy*. Included are those changes ostensibly enacted in support of the homeowner. The pace of the economic recovery and the long-term personal financial success of all mortgaged homeowners depend upon the outcome.

The huge debtor class of homeowners (80% of California homeowners have mortgages) can preserve its ability to recover from a general financial crisis and create a future for itself collectively. However, it needs to emulate the bankers and rally to advocate political positions which allow mortgaged homeowners the same privileges rentiers take for granted. Perhaps most essential among these privileges is the existing guilt-free ability to legally walk away from mortgage debt in California. Within their own households, every California homeowner is *"too big to fail."*

Chapter 3 Summary

The rentier class is made up of those who lend money or let real estate. The debtor class comprises those who borrow or rent. Both exist in opposition to each other; the latter pay, and the former collect. As a result, the nation is divided into two separate economic classes, each of which depends upon the other.

As businesses, banks work in their own best interest, and their continued financial success indicates their business and political strategies are effective. Mortgaged homeowners had no voice until 2011 when the federal government created the Consumer Financial Protection Bureau (CFPB) as a first-of-its-type agency designed solely to protect borrowers. Transparency at the window for mortgage applications, processing, funding and remediation is now firmly in place, functioning and quickly became customary.

Government funded projects are advocated as necessary Keynesian stimulus to repair the economy by elevating it to a level of activity that will be self- sustaining when the stimulus ends. Federal stimulus projects enacted during the Great Recession recovery did very little to improve the long-term status of homeowners threatened by foreclosure.

In contrast, excess speculator liquidity fueled by QE Fed programs has done much more to reflate home prices. The recent rounds QE of had the direct, immediate and pronounced effect of bolstering share and bond prices, commodities markets and income producing real estate, but not homes (except for speculation's effect in the low-tier price range).

Chapter 3 Key Terms

Chapter 4

Capitalization rates, explained

Learning Objectives

After reading this chapter, you will be able to:

- understand how the capitalization (cap) rate is used to calculate the annual rate of return produced by the operations of an income property as a percentage of invested capital;
- distinguish the divergent use of cap rates by buyers and sellers in income property transactions;
- on behalf of a seller, state the cap rate when marketing a rental income property as the annual yield from operations based on the asking price;
- on behalf of a buyer, use their cap rate to set the value of a property as the maximum price they are willing to pay based on the property's net operating income (NOI); and
- establish the risk premium rate a buyer needs to include in their cap rate based on risks inherent in the property and due to human and other exterior activity.

Key Terms

capitalization rate (cap) rate
gross operating income (GOI)
net operating income (NOI)
operating expenses
return on capital

What does the cap rate measure?

The **capitalization (cap) rate** is the annual rate of return produced by the operations of an income property and stated as a percentage of invested capital.

Initially when a seller's agent markets an income property for sale, the *cap rate* is presented as the annual yield from rental operations in relation to the seller's asking price.

capitalization (cap) rate
The annual rate of return on invested capital based on net operating income (NOI) produced by the operations of an income property. The cap rate is calculated by dividing the NOI by the property's price.

net operating income (NOI)
The net revenue generated by an investment property. It is calculated as the sum of a property's gross operating income less the property's total expected operating expenses. [See **RPI** Form 352 §4]

Yield is distinguished from *profit*. Both are stated as percentage figures; both represent a return on invested capital, typically the price paid for a property. However, a *yield* is the ongoing annual measure of net income generated by the operation of a rental property (residential or commercial).

The yield a rental property produces is the property's annual **net operating income (NOI)**.

Profit, on the other hand, is the measure of gain realized over the entire period of ownership on the sale of property at a price greater than the price paid. Tax wise, profit is classified as a **capital gain**. It is calculated on a sale as the difference between the sales price and the price paid to acquire and improve the property, minus transaction costs. (*Depreciation recapture* is taxed at a higher rate than a capital gain.)

Further, profit is a one-time event, taken on the sale of a capital asset. Conversely, yield is the annually continuing receipt of net operating income (passive or portfolio) calculated for each year of ownership of a rental property. [See Chapter 35]

The seller's use of the cap rate, in application

The seller's cap rate is not the same as the cap rate used by an income property buyer when setting the price in negotiations.

The seller's application of the cap rate is the annual percentage yield the property's NOI represents of their asking price. In other words, it is the percentage of the asking price the annual yield – NOI – represents.

The asking price is typically set first with the cap rate deduced based on the NOI, the reverse procedure from the buyer's use of a cap rate.

The buyer and seller hold divergent desires with the cap rate. For a seller, the lower the cap rate the better, as a low cap rate means a higher selling price — and greater profit. [See Chapter 9 and 10]

The buyer's use of the cap rate, in application

The buyer's application of the cap rate is to first set it is as the annual percentage yield sought by the buyer. Once set, it is next applied to the property's NOI to calculate the likely purchase price the buyer will pay.

Again, the buyer's setting and application of a cap rate is in reverse order of the analytical steps used by a seller and seller's broker to determine the cap rate they present.

A buyer analyzes a property's worth using a cap rate pre-established by the buyer. This analysis is based on the long-term outlook for the particular property. The cap rate the buyer establishes is applied to the property's *NOI* to calculate the property's present value. Thus, the buyer sets the maximum price to be paid to acquire the property based on the NOI, the NOI being confirmed prior to contracting (or closing) by a **due diligence investigation** of rents and expenses. [See Chapter9]

For a buyer, the higher the cap rate the better, as this means a lower purchase price (and greater yield).

When searching for income property to acquire, it is the buyer who makes the initial offer. Thus, it is the buyer who needs to determine a cap rate sufficient to justify investment in each property under consideration. The rate for each property differs depending on the condition of the property improvements, the tenant demographics and location.

Settling on a cap rate without considering these conditions is financially unsound — unless the property's land value is greater than the capitalized value of the income generated by what is then the property's obsolete improvements.

Calculating the cap rate

The cap rate is calculated by dividing a property's net operating income by either the price asked (for the seller) or the price offered (for the buyer). The rate for each the seller and the buyer will vary.

For a buyer to find the value of a property, and further, the maximum price they ought to pay to own it, the buyer first needs data on the property's:

- **gross operating income (GOI)**, equal to the annual rent amounts presently received from the property's tenants and the scheduled rent amounts for vacant units after a *vacancy factor reduction* [See **RPI** Form 352-1];
- **operating expenses**, including taxes, insurance, maintenance, repairs/replacements and all other management costs — information which helps anticipate operating expenses includes the *age*, *quality* and *care* of the structure and components; and
- **the capitalization rate** the buyer devises as appropriate to evaluate property of its type and condition. [See **RPI** Form 352]

gross operating income (GOI)
The actual income received from all sources that property operations is expected to generate over a 12 month period, from which expenses are paid, mortgage payments made and reserves set aside, any remaining cash being spendable income.

operating expenses
The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

Editor's note — To calculate the vacancy factor reduction from scheduled income, start by obtaining the vacancy rate actually experienced by the property for the past year. If this is made unavailable, use an average for the area and property type (or disregard the property as not for sale due to a deliberate lack of known information).

For example, consider a property that has 50 units. On average, five units are vacant each month during the past year. Here, the property has a vacancy rate of 10%. Thus, include a figure of 10% in lost rents to set the anticipated GOI.

The first two factors allow the buyer and the buyer's broker to find the property's **net operating income (NOI)**. To do this, you use the formula:

GOI – operating expenses = NOI

For instance, a new 10-unit residential rental property produces an annual bankable GOI of $120,000. The annual operating expenses likely to be experienced during the first year of ownership are $30,000. Therefore, the NOI is $90,000.

The NOI constitutes:

- a *return of capital invested* – mortgage and equity financing – used to purchase and improve the property (also called **recovery of invested capital** allocated to improvements, not land); and
- a *return on capital invested* (the **taxable yield**).

Mortgage interest, depreciation deductions and income taxes are separate personal issues of the owner, not a burden affecting rental income and operating expenses of the property.

Calculating the maximum price to acquire the property

On the buyer's initial exposure to the property and gathering of its operating data — all the while ignoring the asking price and cap rate provided by the seller's agent — the buyer next determines the rate of return (cap rate) acceptable to own this property in the future. Only when the buyer sets a sufficient cap rate — based in large part on the observed nature and condition of the property, tenants and location — can the *maximum price to acquire the property* be calculated (and then only if they have a verified NOI).

return on capital
An annual yield on invested capital, stated for investment purposes as a percentage of equity capital contributed to fund the costs of acquisition and improvements of a property, represented by the property's net operating income (NOI) less interest paid on mortgage debt, also called return on investment (ROI).

To calculate the purchase price a prudent buyer ought to pay, the following formula is used:

NOI / cap rate = purchase price

On the other side of negotiations, *the seller* does not use a cap rate to set the asking price. The seller's thinking is to first set the price based on the amount they want for the property. It then becomes the task of the seller's agent to extrapolate a cap rate for inclusion in their property's marketing package. [See Chapter 8, 9 and 10]

The formula the seller's agent uses is:

NOI / asking price = cap rate

Continuing the previous example, the NOI is $90,000. The seller's agent first introduces the cap rate concept of evaluation when marketing the property. In this case, the listing price the seller is asking is $1.3 million. With the price set by the seller and a reliable NOI known by the seller's agent, mathematically $90,000 / $1,300,000 is 0.069. Expressed as a percentage (multiplied by 100), the **cap rate** is 6.9%.

Buyer's determination of an acceptable cap rate

An acceptable cap rate varies from property to property, location to location, buyer to buyer, year to year and even month to month in some periods of economic distortion. In a mortgage market where forward, long-term interest rates will be higher, today's cap rate needs to reflect this expectation of rising rates.

If not, the price paid set using a cap rate based on today's (or yesterday's) historically low interest rates (reflecting low inflation and low real margins) will in *real terms* produce a loss for the buyer on a resale during the next two decades. Cap rates going forward will rise as they track increases in both mortgage rates and the demand for money when economic expansion begins (post-recovery) and we escape from the zero lower-bound interest rate trap of 2009-2014.

Very low cap rates for income property evaluation seem acceptable to impatient and inexperienced cash-heavy, interest-earning individuals with few investment opportunities. However, buyers and their agents need a discussion to contrast the coming years' interest and cap rates with current rates.

Other buyer considerations

The cap rate does not reflect every aspect an investor buyer needs to consider when setting the maximum price they will pay. Application of a cap rate formula alone does not account for:

- required *renovation and rehabilitation* of the property (which requires additional capital beyond the purchase price to eliminate the obsolescence);
- the cost of hiring a *property manager* and of other services needed to operate the property (when not included as an operating expense) [See Chapter 12];
- a mortgage with an interest rate exceeding the combined rate of inflation and *real* return on investment used to set the cap rate; and
- a *final/balloon payment* in a mortgage.

Thus, a buyer purchasing a property subject to an existing mortgage or funded by a new mortgage needs to set the cap rate higher than the interest rate on the mortgage to justify the risk of loss. This spread covers items such as recovery of the investment or reserves for replacement, and risks presented by changes in demographic (tenant) demands.

Editor's note — Any adjustable rate mortgage (ARM) or due-date financing presents a particularly troublesome risk of loss due solely to future increases in interest rates — which of course reduce property values.

Further, the primary source of funds for the owner's payment of a purchase-assist mortgage is the property's NOI. The NOI remaining after deducting the interest paid on the mortgage represents the earnings attributable to the buyer's cash equity investment. Thus, this remaining portion of NOI needs to produce a much higher percentage yield on the buyer's leveraged equity investment (cash) to offset the risk of the buyer's cash being subordinate to mortgage financing.

Cap rate sets the purchase price

The setting of a cap rate for a property by prospective buyers is imperative if the buyer is to independently determine the purchase price they will pay.

On the flip side, sellers have little concern for the cap rate (beyond marketing purposes). Sellers typically set their asking price for their property based on their desired profit, or more likely a price illusion. It is the seller's agent who then is left to tweak the gross operating income and expenses to arrive at an NOI that, when related to the asking price, produces a marketable cap rate for the property.

On the other hand, the practical, forward-looking buyer prudently makes an offer to buy a property only at a price based on the cap rate they have independently decided is applicable to this type of property and its condition.

Thus, the buyer's setting of the cap rate requires analysis of:

- a percentage annual *return on capital* the buyer is willing to accept, (say 3%-4%) on a long-term investment containing no risk of loss of invested capital, sometimes called a **margin** or **profit margin**;
- the annual anticipated rate of **consumer inflation** expected over the life of the investment (say 2%) needed to retain dollar purchasing power;
- a percentage annual **recovery of invested capital** or reserve for replacement of structural components, the annual return of the original investment allocated to improvements (say 2%, a 40-year recovery on 75% of investment allocated to improvements), comparable to income tax deductions from NOI for recovery of capital before income remaining is subjected to tax [See Chapter 34 and 35]; and
- a percentage annual premium (say 0%-3%) for the **risk of loss** due to physical obsolescence of the structure resulting from age, any adverse demographics of personal income and population density (economic obsolescence), destruction of improvements due to uninsured casualty losses and other like risks unique to each property.

Risks inherent in the property: the primary catergory of risk

As is the case with any investment, purchasing income property includes an amount of **risk** that some or all the capital (cash and borrowed mortgage funds) will be lost. Thus, the prudent investor asks: how do you include this risk (called a **risk premium**) in the cap rate, in addition to the *real* rate of return and the inflation rate?

There are two types of risk to consider when determining the *risk premium rate* to be included in cap rates:

- risks inherent in the property (the **primary category of risk**); and
- risks due to human and other exterior activity (the **secondary category of risk**).

The *primary category of risk* considers the physical improvements on the property, including their deterioration and declining usefulness through aging, called **physical obsolescence**. Also labeled **depreciation** for tax accounting purposes, it provides for a *return of capital* (*capital recovery)* over the remaining economic life of the improvements before the land value exceeds the value of the property's income, called **economic obsolescence**. [See Chapter 34]

Depreciation is both an investment fundamental and a tax deduction. It is an annual allowance for the property's "exhaustion, wear and tear and obsolescence," as properly seen by the Internal Revenue Service (IRS).

For investors, the allowance reserves annually a portion of the NOI, classifying it as a return of capital allocated to improvements. At the same time, improvements made to a property as excessive maintenance expenses often increase the property's value by allowing the owner to charge more rents. [See Chapter 34]

The primary category of risk can be easily accounted for. However, the *secondary category of risk* is less tangible and therefore more difficult to translate into a percentage figure to develop the cap rate. Nonetheless, the primary and secondary categories of risk combined establish the **risk premium** part of the cap rate.

Risks due to human and exterior activity: the secondary catergory of risk

The secondary category of risk includes the "human" and exterior influences on the property's value. These risks include:

- the **creditworthiness** and level of employment diversity in current tenants, an employer issue;
- the coming expiration of current leases, which are preferably staggered, a management issue [See **RPI** Form 352-1];
- competition from nearby, similar property (existing and future construction), a market issue;
- a history of crime committed on or near the property, a security issue [See **RPI** Form 321];
- long-term income and wealth changes in the area surrounding the property, a demographic issue; and
- changes in **zoning,** retrofitting, habitability and fire ordinances or regulations, a political issue. [See **RPI** Form 185]

An example of demographic change can be seen in the changing attitudes about suburban versus urban living. Whereas the wide lawns and *McMansions* of suburban living used to call families by the droves, the amenities and jobs located in cities have caused a shift in housing preference among the next generation of **first-time homebuyers**. Thus, where a suburban income property earned high rents in the past, over the next decade rents are expected to decrease as demand of more skilled employees transfers to urban areas. Further, a decrease in demand reduces property values.

Zoning changes also affect a property's rents, and in turn *value*.

Chapter 4 Summary

The capitalization (cap) rate is the annual rate of return produced by the operations of an income property and stated as a percentage of invested capital.

Initially when a seller's agent markets an income property for sale, the cap rate is presented as the annual yield from rental operations in relation to the seller's asking price. The yield a rental property produces is the property's annual net operating income (NOI).

The buyer's application of the cap rate is to first set it is as the annual percentage yield. Once set, it is next applied to the property's NOI to calculate the likely purchase price the buyer will pay.

For a buyer to find the value of a property, the buyer first needs data on the property's:

- gross operating income (GOI), equal to the annual rent amountsreceived from the property's tenants and the scheduled rent amounts for vacant units after a vacancy factor reduction;
- operating expenses; and
- the cap rate the buyer devises as appropriate to evaluate property of its type and condition.

The first two factors allow the buyer and the buyer's broker to find the property's NOI using the following formula:

GOI – operating expenses = NOI

The buyer next determines the cap rate acceptable to own the subject property in the future. Only when the buyer sets a sufficient cap rate can the maximum price to acquire the property be calculated.

An acceptable cap rate varies greatly depending on the property, location, and objectives of the buyer. In a mortgage market where forward, long-term interest rates will be higher, the cap rate needs to reflect this expectation of rising rates. If not, the price paid set using a cap rate based on low interest rates will produce a loss for the buyer on a later resale.

To calculate the purchase price a prudent buyer ought to pay, the following formula is used:

NOI / cap rate = purchase price

The cap rate does not reflect every aspect a buyer needs to analyze when considering purchasing an investment property. Other factors include:

- required renovation and rehabilitation of the property;
- the cost of hiring a property manager and of other services needed to operate the property;

- a mortgage with an interest rate exceeding the combined rate of inflation and real return on investment used to set the cap rate; and
- the existence of a final/balloon payment in a mortgage.

As purchasing income property includes an amount of risk, a prudent investor includes a risk premium in the cap rate. There are two types of risk to consider when determining the risk premium rate to be included in cap rates:

- risks inherent in the property (the primary category of risk); and
- risks due to human and other exterior activity (the secondary category of risk).

Chapter 4 Key Terms

capitalization (cap) rate .... **pg. 24**
gross operating income (GOI) .... **pg. 25**
net operating income (NOI) .... **pg. 24**
operating expenses .... **pg. 25**
return on capital .... **pg. 26**


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Chapter 5

Rent: the requisite to property value

Learning Objectives

After reading this chapter, you will be able to:

- understand how rent influences property valuations;
- quickly approximate fair market value; and
- distinguish between actual and implicit rent.

Key Terms

capitalization rate (cap rate)
gross revenue multiplier (GRM)
implicit rent
income approach
net income multiplier (NIM)
price appreciation

Rent determines a property's fair market value

The rent a property commands is fundamental to the setting of that property's value, called **fair market value (FMV)**.

For property valuation purposes, rent is categorized as either:

- the *gross operating income*, analyzed based on a **gross revenue multiplier (GRM)**; or
- the net *operating income (NOI)*, analyzed based on a **capitalization rate (cap rate)** or **net income multiplier (NIM)**. [See Chapter 4]

NOI is the total revenue remaining after deducting operating expenses from rents actually received as gross operating income.

Determining a property's value using the GRM or cap rate is called the **income approach**. The *income approach* historically is applied to limit the price a buyer will pay and a mortgage lender will lend on a property.

income approach
The use of a property's rental income to set its value.

net income multiplier (NIM)
The property's price as a multiple of the net operating income.

capitalization (cap) rate
The annual rate of return on invested capital produced by the operations of an income property. The cap rate is calculated by dividing the net operating income by the property's price.

gross revenue multiplier (GRM)
Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.

However, when the current cost to replace the property or the price to acquire comparable existing properties is less than the value set by the income approach, these other methods are used to further limit the FMV.

With the income approach to valuation, the amount of rent a property generates is converted into that property's *FMV* by applying an appropriate cap rate for real estate investments to the NOI. Cap rates used for businesses are conceptually and economically inappropriate for application to real estate investments. Nevertheless, Wall Street money managers have erroneously applied business rates to rents and mortgages during the past several years.

Wall Street banker schemes include *real estate investment trusts (REITs)* and *adjustable rate mortgages (ARMs)*. ARMs are bundled into pools and sold as fractional participations in mortgage backed bonds (MBBs).

Calculation of approximate value

The *rule of thumb* for a quick calculation of an income property's approximate value has historically been to multiply the monthly scheduled rent by 100. Scheduled rent is the amount of rent anticipated to be received for all units if currently occupied.

Approximate value is calculated by multiplying the scheduled annual rents by a factor of 8.3. These rules are applied to see when the price asked for a property is reasonably related to the property's likely value, and thus worthy of making an offer to buy or entering into a *due diligence investigation*.

From 1999 to 2007, income property values in most of California defied any such analysis with prices artificially soaring to nearly 200 times monthly rents. The return to the reality of 100 as a multiplier brought on by the 2008 recession was brutal, especially for REITs with properties in California. However, by 2016 prices on low-tier priced housing were back to the 2007 level of around 200 times monthly rents, due mostly to nominally low interest rates on FRMs.

Actual or implicit rent is the price for use

Rent is the price paid (or implicitly paid) for the occupancy and use of space, whether the user-occupant is a tenant or an owner. A tenant pays actual rent, while an owner occupying their property is charged with paying **implicit rent** (to themselves as the owner).

Implicit rent is the dollar amount of the value the owner receives by occupying the space themselves, be it shelter as the owner's residence or to house their trade or business. Implicit rent is an amount equivalent to the rent a tenant will pay to rent the same space.

implicit rent
The value of an owner's use of their property to house themselves or their business.

Further, tenants set rents, not landlords. Typically, tenants can afford to pay between 31%-38% of their income as rent to a landlord. As wages paid to local employees rise, rents also rise since the employee has more money to spend. Homeowners can afford to spend the same percentage of income on principal and interest payments to a mortgage lender and carrying costs of the property.

The exception to this rule continues to grow into 2018 and beyond, as rents soar beyond local incomes in parts of California, including Los Angeles and San Francisco. In turn, tenants spend more of their income on rent to maintain the same standard of living and have less to spend on other goods and services that contribute to local economic growth. The issue is a supply-demand imbalance and will only be fixed by more multi-family rental housing built in these most desirable parts of coastal California.

Landlords can only watch and respond

Lowering rents to attract tenants to rent vacant units initially cannibalizes tenants from other rental properties, a *zero-sum game*. Eventually, increases in the local population and job openings help fill up vacant units (residential and commercial) and reduce inventories of unsold properties. Also, long-planned intervention by the Federal Reserve (the Fed) will cause mortgage rates to rise and continue up for the next two-three decades. When rates remain elevated for sufficient time they will drive wage earners and businesses toward rental properties and away from ownership.

Without sufficient new construction for a growing population, availability of all types of housing and commercial property runs short of the local population's need for space. Until starts catch up, landlords are able to raise rents beyond 31%-38% of a wage earners' income, properly called **price appreciation** since it is not the product of consumer inflation.

price appreciation
Any increase beyond the rate of consumer inflation above the price paid for property experience by the owner on its resale.

This move will bring landlords excess profits for a limited time. Soon the excess earnings will spur the inevitable ruinous competition from builders. When rents are high enough, valuations based on rents then justify the cost of new construction. Without new construction, which is harshly restricted by **zoning regulations**, investors convert hotel space into condos, as was seen in the early '90s, and tenants orchestrate rent control ordinances, as occurred in the early '80s, and the price of property and rent will bubble.

Mortgage rates compete with rents affecting ownership

Rent charged by property owners is the economic equivalent of *interest rates* charged by money lenders. Both are a return for letting/lending an asset; one being real estate, the other cash. Both assets by agreement are to be returned (to the Rentier). Thus, rent charged to tenants by landlords is in direct competition with the interest paid by buyers on **fixed rate mortgages (FRMs)** made by lenders.

Tenants who wish to buy and occupy comparable space as an owner leave vacant rental space behind in the turnover. Builders, mortgage lenders and sales agents strive daily to convert tenants into owners. Their goal has been sold to Congress as being good for the country (but not very good by 2008 for *Freddie Mac* and *Fannie Mae* and the other third of the mortgage market lenders or negative equity homeowners).

The coupling of rent and mortgage payments as competitors for the dollars a user of property has to spend on occupancy is straightforward:

- a landlord expects a creditworthy tenant to pay a rent amount no greater than 31%-38% of the tenant's gross income; and
- a mortgage lender expects a creditworthy owner/occupant to pay monthly interest (and a de minimis amount of principal) on a maximum FRM and property carrying costs equal to 31% to 38% of their gross income.

These are nearly identical standards for the monthly out-of-pocket cost of occupancy; one applied to wage earners by landlords, the other applied to wage earners by mortgage lenders.

Recessionary pricing competes with rents

A further complication for rent stability during a recession is the accompanying *fall in the price of properties*. Property prices fall normally during a routine business recession. When prices drop enough, tenants benefit by becoming owners, since their mortgage payments will be lower than the rent paid by a tenant.

Several other factors influence the future trend in rents. These factors include local changes in population density (usually through improved zoning), foreclosure rates, vacant single family residences (SFRs) and condos, property values, wages, employment, migration/immigration, social mores, rent control, rental age population and household formations.

Chapter 5 Summary

The rent a property commands is fundamental to the setting of that property's value, called fair market value (FMV). The rule of thumb for a quick calculation of an income property's approximate value has historically been to multiply the monthly scheduled rent by 100.

Rent is the price paid (or implicitly paid) for the occupancy and use of space, whether the user-occupant is a tenant or an owner. A tenant pays actual rent, while an owner occupying their property is charged with paying implicit rent (to themselves as the owner).

Chapter 5 Key Terms

Chapter 6

Types of income property and locations

Learning Objectives

After reading this chapter, you will be able to:

- weigh the pros and cons of the effect various types of income property have on brokerage fees;
- analyze the suitability of different locations of income property for buyer investment;
- select the type of income property to specialize in and the location for your practice; and
- brand yourself as an expert in your chosen type of income property.

Key Terms

anchor tenant	**income producing property**
consumer confidence	**mixed-use property**

Be an expert — or be a dilettante

Consider an individual who recently became licensed as a California real estate agent. The agent is interested in representing buyers and sellers of **income producing properties**. Eager to begin, the agent enters into an employment agreement with the first broker who offers to hire them. [See **RPI** Form 505]

income producing property
Residential or commercial income property held by the ownership for the long-term to earn income through leasing operations and price appreciation.

The broker is familiar with the local community but deals exclusively with residential properties sold to owner-occupants.

The agent's objective is to brand themselves as a *jack of all trades*. The agent believes the more types of property they are able to list, the greater their chances of locating an owner or buyer and closing a deal to generate personal income.

Thus, the agent aggressively seeks listings for a variety of income producing properties, including:

- apartments;
- industrial;
- retail;
- office;
- mixed-use; and
- agricultural land.

The agent struggles with owners and prospective buyers and tenants to obtain a listing, i.e., *employment*. With no evidence of sufficient experience or expertise, the owners of local properties are unwilling to enter into the listing agreement to sell or lease sought by the agent. [See **RPI** Form 102 and 110]

Further, without a track record, no tenants or buyers are motivated to work with the agent. After months of scrambling to no financial advantage, the agent determines they need to adjust their strategy to be successful.

An employing broker with commercial experience

Continuing our previous example, the agent recalls seeing an abundance of commercial property signage for a local broker. The agent also frequently heard about the local broker at marketing sessions and via word-of-mouth when dealing with other agents. Based on the broker's high profile in commercial properties, the agent contacts the broker about employment as their agent. [See **RPI** Form 505]

At the outset of their interview, the broker asks which *type of income property* the agent sees as their specialty.

During the agent's brief time in the field, the agent developed a primary interest in **industrial space**. The broker has several agents employed who are dedicated to local industrial properties and are willing to mentor the agent in an apprenticeship *team arrangement*.

As part of the interview, the agent and broker set annual net income goals for the agent spanning the next two years. They calculate the gross income from sales and leasing needed to meet the agent's net income goal. [See **RPI** Form 504]

On determining the type of property and market area the agent will work as part of a team, the broker employs the agent. The agent is now positioned to formally begin a serious foray into the world of income property brokerage.

Choose your property specialization

When working in the income property **sales market,** agents and brokers fulfill two critical roles by acting as:

- a *buyer's agent* whose objective is to locate an income property which meets the financial objectives of the investor; or

- a *seller's agent* whose objective is to locate a real estate investor or user who purchases their property.

Editor's note — Throughout this material, the term "investor" is used to denote both a singular investor acting on their own account or a group of investors as a real estate syndicate. [See Chapters 36–39]

When working in the income property **rental market**, brokers and agents function as:

- a *tenant's leasing agent* whose objective is to locate a rental property which fulfills the business objectives of the tenant who will occupy the property; or
- a *landlord's agent* whose objective is to locate a commercial tenant to occupy and use the property under a long-term lease. [See Chapter 12 and 13; see **RPI** Form 552]

Income producing properties are classified as either:

- **residential property**, such as one-to-four unit residential properties, condominiums and multi-family apartment complexes of five or more units; or
- **commercial property**, also called **nonresidential property**, ranging from office complexes and industrial properties to retail space.

Though the use of the properties are different — shelter in the case of residential property and as a place to conduct business for commercial property — both types of property are owned by investors and rented to generate income.

A real estate investor as a buyer has multiple types of income property to choose from to generate the return they seek in a manner compatible with their tolerance to risk and asset management.

Just as a real estate investor tends to focus on a specific type of property for investment, income property agents and brokers need to specialize and market themselves as most knowledgeable in a particular type of property (read: an *expert*).

Each property type and location has advantages and disadvantages that are analyzed, marketed and discussed with investor and user clients. Thus, successful income property brokers focus on a particular type of property and attendant location to brand themselves as the expert.

Industrial property — a portfolio investment

Industrial property is further broken down into varying sub-classifications based on the tenant's use of the space, including:

- warehousing;
- heavy and light manufacturing;
- distribution and shipping;
- equipment operators;
- repair shops; and

- research and development.

Further, some *industrial property* includes partial or full office build-outs which diversifies the use of the property for related business operations.

The functionality of the industrial space dictates what type of tenant is able to use it. The attributes directly affecting a property's functional use include:

- the configuration of the property, including whether it contains office space;
- the number, height and type of ground loading doors;
- ceiling clearance;
- the presence of sprinkler systems;
- loading ramps and docks;
- the location of the property relative to major transportation arteries, such as freeways and mass transit; and
- whether the space allows for specialization (such as the use of large mechanical equipment, freezers or fork lifts).

Industrial properties generally encourage long-term leases as significant modifications are often needed to meet the business needs of prospective tenants. However, once the lease ends, significant alterations are often required again to make the property suitable for the next tenant's use. [See **RPI** Form 552]

The *operating costs* of industrial property incurred by the owner tend to be lower than for other types of commercial income properties, such as retail or office space. As an industrial property is designed to be purely functional, the investment in improvements does not include the costs for *hedonistic amenities* and other aesthetic concerns as required in office or retail properties.

Further, an industrial property requires less intensive management and maintenance during the term of a tenant occupancy than most any other type of real estate ownership.

Retail property — reliant on consumer confidence

anchor tenant
A large, well-branded retailer strategically situated in a multi-unit shopping complex to draw foot-traffic and consumers for the general benefit of all tenant occupants in the complex.

Retail commercial property has a high degree of variety in its use by tenants to make goods and services available to consumers.

Retail commercial space is often occupied by a single tenant, as is the case with a freestanding restaurant in a pedestrian zone, bank or a large *box store*.

Generally, a retail property houses multiple tenants each with their separate space, as is the case in a *strip mall* or large shopping complex.

In the instance of multi-tenant retail property, many have two or more large well-known retailers such as a national clothing or grocery store that draws foot-traffic and generates business for all tenants in the development. These dominant, high profile tenants are called **anchor tenants**. *Anchor* *tenants* typically enhance the fundamentals of a property for the owner as the rental income stream generated by it and neighboring tenants is more stable (though the anchor tenants pays a reduced per square foot rental rate).

Often, larger retail centers have one or more ancillary multi-unit buildings that contain smaller retail tenants called a **commercial retail unit (CRU)**.

The demand for retail space has many factors. The value and investment desirability for retail space is uniquely sensitive to demographics of the property's location, traffic, and accessibility. Intuitively, retail properties perform best during the virtuous economic cycle when **consumer confidence** is high and retail sales growth is strong.

consumer confidence
An economic indicator measuring the current level of optimism consumers feel about their personal financial situation and the present state of the broader economy.

Office properties — a parallel to the local economy

Many **offices properties** are located in high traffic urban locations in downtown cores or sprawling multi-tenant suburban office parks. Office tenants pay premium rents when the building is sufficiently upgraded and in a desirable location.

Office properties house many of the white-collar professions in the modern economy, such as finance, accounting, law, insurance, real estate, management and administration. However, in order to accommodate the demands of the professional occupant, commercial office buildings have a much higher operating cost and demand on management than industrial properties.

Tenant demand to lease office space is inextricably linked to the local economy and availability of workers as the need for space is contingent on employer requirements for office space. The demand for office space thus ebbs and flows with local consumer demand for services office tenants provide. Thus, returns from office properties are highly variable as they are contingent on local economic conditions.

In times of economic downturn, as recently experienced during the **Great Recession**, commercial office properties experience high vacancy rates. In times of economic prosperity, office properties perform quite well as demand increases for office space and rental rates rise rapidly.

Apartment complexes — a more stable investment

Regardless of fluctuations in the economy or where we are in the economic cycle, the local population always needs a place to live.

Apartment complexes or other multi-family residential properties offer rather consistent vacancy rates and returns compared to other types of properties. The result is less risk of disruption to the cash flow generated for the operation and ownership of multi-family properties.

Further, the loss of a single tenant has a minimal impact on the bottom line as this risk is spread across numerous units. Thus, vacancies have less impact than is the case for a single family residence (SFR) or a single tenant commercial property left with zero rental income when the single tenant vacates.

With multiple-tenant property ownership, the owner is financially better positioned to weather a singular disruption in income when a tenant becomes unable to pay rent.

When considering the desirability of owning an apartment complex, the investor needs to decide whether extensive common areas used by all residents and maintained by the investor is reasonable, such as:

- swimming pools;
- exercise facilities;
- entertainment areas; or
- an outdoor barbeque installation.

Apartment complexes experience higher general maintenance costs relative to the rent received than most other types of income properties. Though the cost of repairs and upkeep are spread over multiple units, the existence of plumbing, gas and electric fixtures and appliances in each unit increase the frequency of repairs and replacements.

Also, due to their condensed nature, damage to one unit can cause damage to a neighboring unit, as occurs when an unexpected release of water in one unit leaks into another unit.

Further, the turnover rate in apartments is higher than other types of property and thus increases the cost of operations. Though demand for rental space is consistent within a community, apartment complexes by the nature of their tenancies facilitate transitory living arrangements. Each time a tenant vacates, the unit needs some level of overhaul to eliminate accumulated wear and tear and freshen up the unit before a new tenant is located.

Additionally, the investor incurs the expense of property management services to coordinate tenant turnover, maintenance and rent collection. When a complex has 16 or more units, a resident manager needs to live onsite to handle these operations.

One-to-four unit SFRs — a store of wealth

Investors interested in residential properties can also choose to purchase single or two-to-four unit SFRs for rent to tenants.

When the neighborhood surrounding an SFR consists of adequately maintained properties, the SFR retains a *continuing demand* by residential tenants. Older SFRs are often renovated with upgrades to increase the amount of rent the property commands from tenants.

When an investor wants to cash out their SFR investment, it is sold more readily than an apartment complex or other type of property. SFRs are highly *liquid assets* marketed and sold on short notice due to the availability of highly leveraged financing and a large reservoir of home buyers, speculators and investors compared to any other type of property.

Occupancies in rented SFRs tend to stay for longer periods than tenants in apartments. Thus, less time is needed by the investor or a property manager to deal with vacancies. Once a suitable tenant is located and takes possession, the property is operated with fairly minimal management by the investor.

However, the SFR investment strategy is inherently less diversified, unless the investor owns several SFR properties. Once an SFR tenant leaves, the investor receives no rental income from the property until another tenant is located and enters into a rental or lease agreement. [See **RPI** Form 550 and 551]

SFRs experience lower operating expenses as a percentage of rental income. Typically, an SFR lease shifts much of the utilities and periodic maintenance to the tenant, such as landscape maintenance, water, pool care, cable/TV, internet and sanitation.

When property is located in a homeowners' association (HOA) community, the HOA is typically responsible for maintaining the structural improvements, common areas and exterior of the property. However, the owner pays the HOA fees and special assessments, unless the lease agreement passes the annual HOA charge onto their tenant.

Editor's note — To retain the value of an SFR property and maintain its curb appeal, owners often retain responsibility for landscaping. Tenants who fail in their obligation to maintain landscaping threaten the value of the owner's investment.

Mixed-use properties — the best of both worlds

Mixed-use properties feature a combination of both commercial and residential space. The buildings feature ground floor stores with apartments above, or multi-story structures divided vertically between commercial and residential tenants. These properties are typically located in dense urban areas found in Los Angeles, San Diego and San Francisco.

mixed-use property
An urban real estate development which combines residential and commercial uses.

Mixed-use properties present multiple advantages for investors. Due to their multifaceted nature, they produce two diverse income streams making multi-use properties more resilient to fluctuations in the local economy and statewide business cycles. Further, when the commercial component of the property is sufficiently attractive to create a high degree of desirability, demand for the residential section units is increased, generating higher rents.

Occasionally *anchor tenants* occupy the commercial space, encouraging public foot traffic which further increases demand for space in the development.

The diversified nature of mixed-use properties does present complications for ownership. While producing higher rents, they are less efficient to administrate and thus more costly to manage due to inherent operational conflicts between residential and commercial tenants. Also, with the increased presence of foot traffic brought by the commercial space, security concerns are increased for the residents who live in the project.

Agricultural land — lease it, don't farm it

Agricultural or **raw land** is also owned and used to generate revenue for a property investor as the owner/landlord.

The land may be rented out, such as for farming, public events or parking and storage. Rent for the space is either structured as a flat rate, or as a percentage of the tenant's proceeds that are generated through the productive use of the land.

Agricultural or raw land is often held for the purposes of long-term appreciation and the later sale to a developer to converts the property to a more productive use. In the interim ownership by the investor, the land may be rented to users.

Further, the longer the property is held, the greater the chance zoning changes become more inclusive or desirable, increasing the value of the property as population density and wages increase.

Alternatively, land is held entirely as a *passive investment*, requiring only minimal upkeep and maintenance costs such as vermin control and keeping it free of debris and weeds.

However, property taxes are to be paid by ownership of the property even when the land is unused and not actively generating income. Further, the land might not appreciate in value or simply appreciate at a slower rate than experienced by improved income producing property.

Select a location and become the expert

Concurrent with your analysis of which type of property to focus on to develop an expertise, you need to:

- determine the *neighborhoods* where the types of properties are located in your area of influence; and
- learn the intricacies of the neighborhood features and its economic climate.

As part of the analysis, an agent considers:

- the zoning and uses permitted;
- the physical attributes and condition of the properties in the neighborhood; and
- the current, and if feasible, anticipated operating expenses of the properties in the target location.

Prudent property investors purchase properties in areas *personally familiar* to them to reduce the risks of making a judgment error. First-hand intimacy and knowledge about a community and a particular property are of paramount importance when gauging a property's viability for long-term investment.

Without this tangible knowledge, the investor purchases blind, dependent on others without the benefit of their own observations and familiarity. The same is true of income property brokerage — be an expert in your *own backyard* and do not attempt to be one in a distant city or state.

Study the physical attributes of the neighborhood

When analyzing different locations in a county, begin by gathering zoning maps to identify what uses are permitted. This information is readily available by a visit to the local city or county planning department.

Next, analyze the socio-economic level associated with each of the types of properties available within your area. You can pull much of this demographic information from the website of the California Employment Development Department (EDD), *www.edd.ca.gov*.

The EDD's **data library** contains reliable data regarding industries, occupations, employment levels, wages, and labor force within a specific area, including:

- average annual household income;
- local population density;
- total labor force/non-farm employment; and
- property uses permitted in the location.

Also gather facts on the relevant features of the surrounding area which are part of any marketing package on a property. Important features for investment analysis include:

- neighborhood businesses;
- financial institutions;
- postal and shipping services;
- transportation arteries;
- areas of employment;
- schools;
- fire and police facilities;
- natural resources; or
- unique local attributes.

Analyze a location's *safety and security risks* by having a conversation with officers at the local police department and viewing the web sites they maintain. [See **RPI** Form 321]

Study the economic attributes of the neighborhood

The economic trend of the neighborhood is critical since the properties within it are a store of wealth for their owners. However, the economic fundamentals of the area today are less important than a forward-looking analysis of the area's performance in the future.

To begin, determine whether the location selected is positioned to favorably reflect the value of other developments in the area and local economy — or whether the area is poorly located and likely to miss the regional trends of improvement.

A review of the **economic obsolescence** of the properties within your target area indicates both the owners' attitudes about future valuations of properties and the local government's treatment of the area.

Spend time in the area observing whether the properties are being maintained sufficiently to retain their value. Regardless of their type, properly maintained buildings present an acceptable appearance. Older properties that are properly cared for continue to maintain their aesthetic appeal.

Further, gather data on the level of rent your selected property type receives in the target area. To this end, conduct your own rental survey of the properties within your region, reviewing all published rental data on properties sold or currently on the market.

Lastly, study all real estate advertisements, signs and other marketing materials that are present in the target community. These reveal the *property attributes* most highly sought in the community as well as the tenant incentives currently offered.

Affiliate with a locate expert

Hands-on, *full-time experience* is critical to becoming a successful income property broker who is able to meet sustainable personal income goals.

Your formal study of income property investment and leasing concepts alone is insufficient to make you an expert. Experience as *real world application* directly puts into practice learned income property principles which develop the expertise. Further, actual participation in the market is the opportunity needed to start networking in the selected field and distinguishing yourself in the selected category, and eventually command respect.

Much like a salesperson upgrading to a broker license, a minimum of two years' experience specific to income property brokerage is needed to put an academic understanding of the learned concepts to the practical use prerequisite of expertise.

Thus, a licensee interested in becoming an income property specialist is well advised to become part of a team controlled by a long-term income property broker who has extensive experience rooted in the type of property selected for specialization.

A search of the commercial MLS sites reveals which local broker presently has the most activity on the type of property selected. Further, awareness of real estate signs and marketing materials quickly reveals who are the most active brokers to solicit for employment and tutelage.

Consider the following when searching for an employing broker:

- what **training programs** are available that pertain to the type of property selected;
- who is to be the **mentor** — the broker themselves or other agents in the office;

- how the **mentorship process** works;
- **what is needed** by the broker in exchange for their mentorship;
- **who else on staff** is available to answer questions;
- once trained, whether you will **practice alone** or as part of a **team effort**;
- what types of **marketing and promotional materials** are provided;
- what **technological tools** and support are available and the associated cost;
- what is the **fee split arrangement** provided now and in the future; and
- what **net income** can you expect to earn in the coming two years.

Once a compatible broker is located and a written employment agreement entered into, go to as many appointments and perform as much canvassing and marketing as possible — *get your hands dirty*, so to speak.

Shadow the high performers in the office and attend marketing sessions; absorb lessons from the experience of others. The learning curve is steep, but with the correct mentoring and training, surmountable.

Chapter 6 Summary

When working in the income property sales market, agents and brokers fulfill two critical roles by acting as:

- a buyer's agent whose objective is to locate an income property which meets the financial objectives of the investor; or
- a seller's agent whose objective is to locate a real estate investor or user who purchases their property.

When working in the income property rental market, brokers and agents function as:

- a tenant's leasing agent whose objective is to locate a rental property which fulfills the business objectives of the tenant who will occupy the property; or
- a landlord's agent whose objective is to locate a commercial tenant to occupy and use the property under a long-term lease.

A real estate investor as a buyer has multiple types of income property to choose from to generate the return they seek. The primary types of income property include:

- industrial properties;
- retail properties;
- office properties;
- apartment complexes;

- single family residences (SFRs);
- mixed-use properties; and
- agricultural land.

Concurrent with an analysis of which type of property to focus on, agents need to:

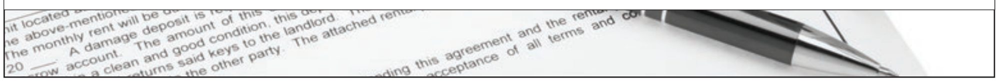
- determine the neighborhoods where the types of properties are located; and
- learn the intricacies of the neighborhood features and its economic climate.

Each property type and location has advantages and disadvantages that are analyzed, marketed and discussed with investor and user clients. Successful income property brokers focus on a particular type of property and attendant location to brand themselves as the expert. The formal study of income property investment alone is insufficient to create expert. Hands-on, full-time experience is critical to becoming a successful income property broker who is able to meet sustainable personal income goals.

Chapter 6 Key Terms

Chapter 7

Income property acquisitions



Learning Objectives

After reading this chapter, you will be able to:

- evaluate an income property for suitability as within a client's investment objectives;
- commence negotiations for the sale of an income property; and
- prepare and submit an offer to purchase income-producing property other than one-to-four residential units.

Key Terms

Annual Property Operating Data sheet (APOD) | **purchase agreement**

Investigating a property's worth

Consider a buyer's agent at an investment property marketing session who picks up a mini-package on a property listed for sale by another agent. The package contains an **Annual Property Operating Data sheet (APOD)**. On review of the APOD, the property appears to match the income property requirements of the agent's client. [See **RPI** Form 352; see Chapter 9 and 10]

Annual Property Operating Data sheet (APOD)
A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

Both the agent and the client drive by the property. The building's exterior appearance is acceptable, and the area surrounding the property looks stable. The property seems properly located for a project of its size and type. It is agreed the agent will gather more information on the property.

The agent obtains a profile on the property from a title company. The title is consistent with information received from the seller's agent regarding trust deeds and vesting.

A property's fundamentals

To begin an analysis of the property, the buyer's agent may contact the seller's agent for more *fundamentals* on the property, asking the seller's agent to produce:

- a *rent roll* spread sheet covering each unit (type, size, tenant, commencement of occupancy, expiration of lease, rent amount and any discount/free rent, payment history, furnishings, etc.) [See **RPI** Form 352-1];
- a two-year *occupancy history* on each unit;
- information regarding *security arrangements* and criminal activity on or around the property during the past year [See **RPI** Form 321; see Chapter 20];
- a *property manager* or resident manager who is available for an interview [See Chapter 12];
- information regarding *maintenance procedures* and the repair services used [See **RPI** Form 324];
- a copy of schedule "B" (CC&R exclusions) to the owner's policy of *title insurance*;
- the lender's name and the balance, payments, interest rates and due date on each existing mortgage; and
- any available information relating to the integrity of the property's condition and the nature of the property's location which may adversely affect the property's value. [See **RPI** Form 304-1]

Agent duty to gather information

The prospective buyer's agent asks for all this information knowing the seller and the seller's agent *owe a duty* to prospective buyers and their agents to inform them of all facts about the property that are *known or readily available* to them which may adversely impact the property's market value. Typically, the seller's agent gathers all fundamental property information in advance and has it ready in a complete marketing package.

If the seller's agent has not yet gathered the facts available to them, they are likely to insist the information is unnecessary before a prospective buyer submits an offer.

However, it is best to commence price negotiations only when disclosures of *all readily available* property data and information have been handed over by the seller or the seller's agent. The confirmation of the *veracity of initial property disclosures* is what a due diligence investigation during the escrow period is all about.

The buyer's agent advises the prospective buyer that the seller or the seller's agent might insist the buyer enter into a *confidentiality agreement* before some of the information requested of the seller's agent is released. Thus, the buyer is compelled to identify themselves to the seller and promise not to release the information received to others.

Otherwise, the seller will not release information on the tenants, their leases and property operations — information the buyer needs to determine the property's worth, and set the price and terms before making an offer.

When the information is received and reviewed, if it warrants further investigation into the suitability of the property for acquisition, the buyer's agent and prospective buyer will personally inspect the premises and any vacant units, and thoroughly discuss operations with those who manage the property.

After receiving these initial disclosures and conducting a minimal investigation, the buyer's agent prepares a purchase agreement if the property still appears to be suitable to the prospective buyer.

By submission of the purchase agreement offer, they *commence negotiations* on the price to be paid and the conditions which need to be met so the prospective buyer can complete a due diligence investigation and confirm their initial expectations about the property. Any counteroffer by the seller sorts out the seller's willingness to permit the prospective buyer to corroborate the property's worth.

Analyzing the commercial income property purchase agreement

The **Commercial Income Property Purchase Agreement**, **RPI** Form 159, is used to prepare and submit the buyer's *written offer* to purchase income property, excluding one-to-four unit residential property.

Terms for payment of the price are limited to conventional financing, an assumption of existing mortgages and a carryback note. Sellers also properly use the *purchase agreement* in a counteroffer situation to submit their *fresh offer* to sell the real estate. [See Figure 1]

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms need to be complete and clear to prevent misunderstandings so any agreement entered into may be judicially enforced. Thus, Form 159 is a comprehensive "boilerplate" purchase agreement which serves as a *checklist*, presenting the various conventional financing arrangements and conditions a prudent buyer is to consider when making an offer to purchase.

purchase agreement
The primary marketing device used to negotiate a real estate sales transaction between a buyer and seller. [See **RPI** Form 150-159]

Purchase agreement components

Each section in Form 159 has a separate purpose and need for enforcement. The sections include:

- **Identification**: The date of preparation for referencing the agreement, the name of the buyer, the amount of the good-faith deposit, the description of the real estate, an inventory of any personal property included in the transfer and the number of pages contained in the agreement and its addenda are set forth in sections 1 and 2 to establish the facts on which the agreement is negotiated.
- **Price and terms**: All the typical variations for payment of the price by conventional purchase-assist financing or an assumption of

existing financing are set forth in sections 3 through 9 as a checklist of provisions. On making an offer (or counteroffer), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.

- **Acceptance and performance**: Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided in section 10, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.
- **Due diligence contingencies**: Contingencies for the buyer's due diligence investigations into income and expense records, rental income statements, hazard disclosures, property condition disclosures and other relevant information to be delivered by the seller are set forth in section 11.
- **Property Conditions**: The buyer's confirmation of the physical condition of the property as disclosed prior to acceptance is *confirmed,* as set forth in section 12, by the seller's delivery of reports, warranty policies and certifications not handed to the buyer prior to entry into the purchase agreement.
- **Closing conditions**: The escrow holder, escrow instruction arrangements and the date of closing are established in section 13, as are title conditions, title insurance, hazard insurance, prorates and mortgage adjustments.
- **Brokerage and agency**: The release of sales data on the transaction to trade associations is authorized, the broker fee is set and the delivery of the agency law disclosure to both buyer and seller is provided for as set forth in section 15, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.
- **Signatures**: The seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.

Preparing the commercial income property purchase agreement

The following instructions are for the preparation and use of the Commercial Income Property Purchase Agreement, **RPI** Form 159. Form 159 is designed as a checklist of practical provisions so a broker or their agent may prepare an offer for a prospective buyer who seeks to purchase conventionally-financed, California-located income property other than one-to-four units.

Each instruction corresponds to the provision in the form bearing the same number.

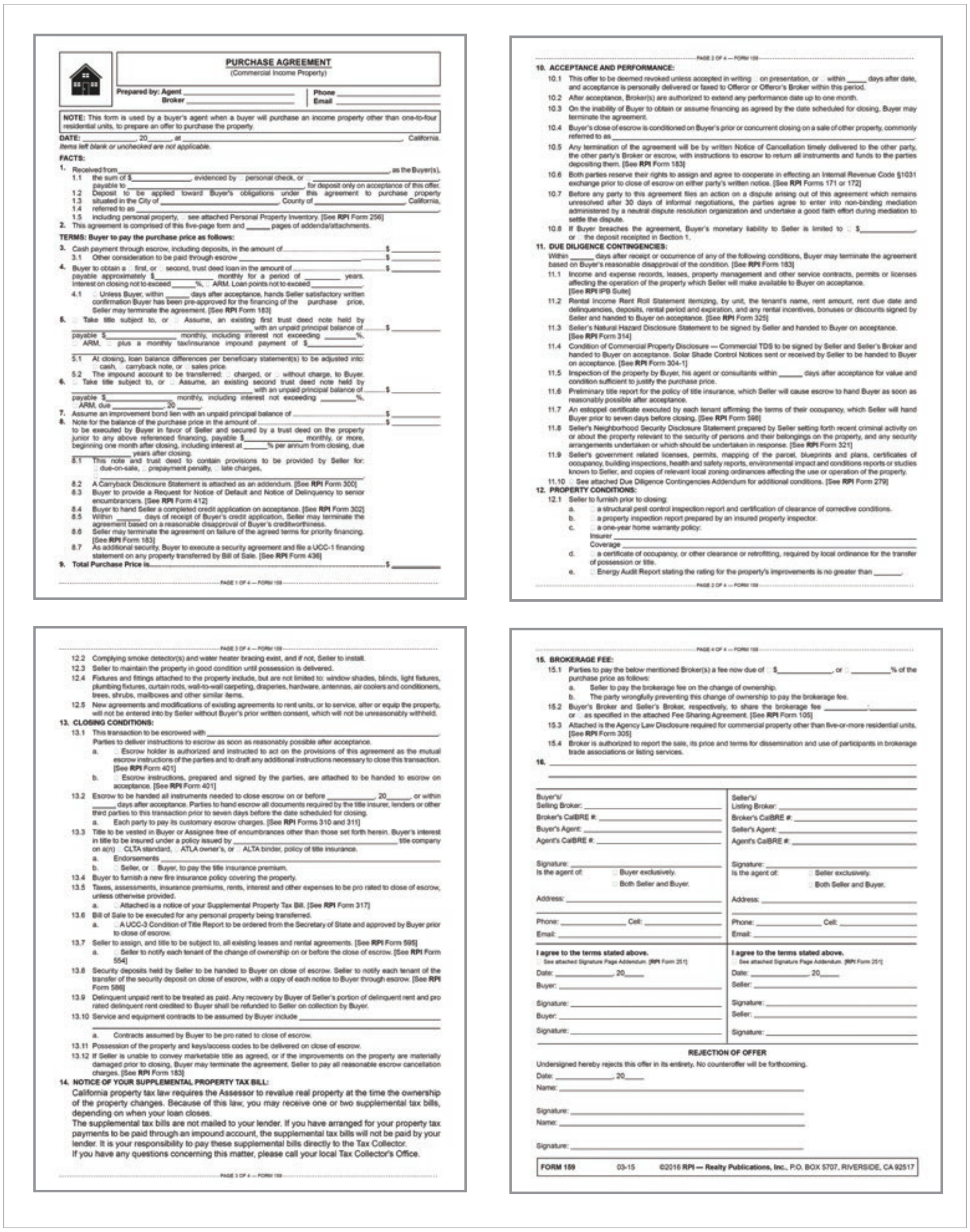


Figure 1

Form 159

Purchase Agreement — Commercial Income Property

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification

Enter the date and name of the city where the offer is prepared. This date is used when referring to this purchase agreement.

Facts:

1. *Buyer, deposit and property*: **Enter** the name of each buyer who will sign the offer.

1.1 Enter the dollar amount of any good-faith, earnest money deposit. **Check** the appropriate box to indicate the form of the good-faith deposit. **Enter** the name of the payee (escrow, title company or broker).

1.2 **Confirm** the deposit is to be applied toward the buyer's obligations.

1.3 **Enter** the name of the city and county in which the property is located.

1.4 **Enter** the legal description or common address of the property, or the assessor's parcel number (APN).

1.5 **Check** the box to indicate personal property will be included in the sale. The seller's trade fixtures to be purchased by the buyer need to be listed as inventory if they are to be acquired by the buyer. [See **RPI** Form 256]

2. *Entire agreement*: **Enter** the number of pages comprising all of the addenda, disclosures, etc., which are attached to the purchase agreement.

Terms for payment of the purchase price

3. *Cash down payment:* **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

   3.1 *Additional down payment:* **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). Enter the dollar amount of its value.

4. *New trust deed mortgage:* **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed mortgage. **Enter** the amount of the principal, the monthly principal and interest (PI) payment, the term of the mortgage and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM). If so, **enter** the index name and any limitations on mortgage origination points.

   4.1 *Buyer's mortgage qualification:* Check the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new mortgage and fails to deliver documentation from a lender indicating they have been pre-approved for a mortgage. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of their pre-approval for the mortgage. [See **RPI** Form 183]

5. *First trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing mortgage or by an "assumption" of the mortgage if the buyer is to take over an existing first trust deed mortgage. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **Check** the box to indicate whether the interest is adjustable (ARM). If so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment.

Terms for payment of the purchase price, cont'd

5.1 *Mortgage balance adjustments:* **Check** the appropriate box to indicate the financial adjustment desired for mortgage balance differences at the close of escrow.

5.2 *Impound balances:* **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing mortgage or by an "assumption" of the mortgage if the buyer is to take over an existing second trust deed mortgage. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the mortgage. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed:* **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — Improvement bonds are debt obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were **ad valorem taxes**, and then fail to prorate and charge the unpaid amount to the seller.*

Seller carrybacks and financing

8. *Seller carryback note:* **Enter** the amount of the carryback note to be executed by the buyer as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

8.2 *Carryback disclosure:* **Check** the box to indicate a Seller Carryback Disclosure Statement is attached as an addendum. [See **RPI** Form 300]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

8.3 *Notice of Delinquency:* **Check** the box to indicate the buyer is to execute a Request for Notice of Delinquency (NODq) and pay the costs of recording and serving it on senior lenders since they

Seller carrybacks and financing, cont'd

will have priority on title to the trust deed securing the carryback note. [See **RPI** Form 412]

8.4 *Buyer creditworthiness:* **Requires** the buyer to provide the seller with a completed credit application. [See **RPI** Form 302]

8.5 *Approval of creditworthiness:* **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.6 *Subordination:* **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a mortgage with priority on title to the carryback note are exceeded. [See **RPI** Form 183]

8.7 *Personal property as security:* **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note. [See **RPI** Form 436]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Acceptance and performance

10. **Acceptance and performance periods:**

10.1 *Delivery of acceptance:* **Check** the appropriate box to indicate the time period for acceptance of the offer. If applicable, **enter** the number of days in which the seller may accept this offer and form a binding contract.

Editor's note — Acceptance occurs on the return delivery to the person making the offer (or counteroffer) or to their broker of a copy of the unaltered purchase agreement offer containing the signed acceptance.

10.2 *Extension of performance dates:* **Authorizes** the brokers to extend the performance dates up to one month to meet the objectives of the agreement — time being of a reasonable duration and not the essence of this agreement as a matter of policy. This extension authority does not extend to the acceptance period.

10.3 *Mortgage contingency:* **Authorizes** the buyer to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

10.4 *Sale of other property:* If the closing of this transaction is to be contingent on the buyer's receipt of net proceeds from a sale of other property, **enter** the address of the property to be sold by the buyer.

10.5 *Cancellation procedures:* **Provides** the method of cancellation required to terminate the agreement when the right to cancel is triggered by other provisions in the agreement, such as contingency or performance provisions. [See **RPI** Form 183]

10.6 *Exchange cooperation:* **Requires** the parties to cooperate in an IRS §1031 transaction on further written notice by either party. **Provides** for the parties to assign their interests in this agreement. [See **RPI** Forms 171]

10.7 *Mediation provision:* **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations.

10.8 *Liability limitations:* **Provides** for a dollar limit on the buyer's liability for the buyer's breach of the agreement. **Check** the first box and **enter** the maximum dollar amount of money losses the seller may recover from the buyer or **check** the second box to indicate the buyer's monetary liability is limited to the good-faith deposit tendered with the offer to buy.

Editor's note — Liability limitation provisions avoid the misleading and unenforceable forfeiture called for under liquidated damage clauses included in most purchase agreement forms provided by other publishers of forms.

Due diligence contingencies

11. *Approval period*: **Enter** the number of days the buyer has to approve or disapprove and cancel this agreement after the buyer's receipt of each item listed below. This section calls for the buyer to complete a due diligence investigation to confirm the representations of the seller and the seller's broker and the pre-contract expectations of the buyer about the property. If the buyer is unable to confirm their expectations, they may waive the requirements or cancel the transaction. [See **RPI** Forms 182 and 183]

11.1 *Operating records:* **Requires** the seller to make income and expense records and supporting documents available to the buyer for inspection as soon as possible after acceptance of the offer. [See **RPI** Income Property Brokerage (IPB) suite; see Chapter 10]

11.2 *Rents and deposits:* **Requires** the seller to prepare a detailed rent roll profile on each occupancy and deliver it to the buyer as soon as possible after acceptance. [See **RPI** Form 352-1]

11.3 *Natural Hazard Disclosure Statement (NHD):* **Requires** the seller to prepare and deliver to the buyer a NHD Statement disclosing the seller's knowledge of the hazards listed on the form. [See **RPI** Form 314]

11.4 *Condition of property:* **Requires** the seller to prepare and deliver a statement disclosing the physical condition of the property as known to the seller. [See **RPI** Form 304-1]

11.5 *Valuation inspection:* **Enter** the number of days after acceptance in which the buyer is to investigate the market value of the property to confirm its value justifies the price the buyer has agreed to pay.

11.6 *Title report:* **Requires** the seller to deliver a preliminary title report to the buyer for review to confirm the condition of title

Due diligence contingencies, cont'd

allows the buyer to use the property as they intended.

11.7 *Tenant Estoppel Certificate:* **Requires** the seller to produce Tenant Estoppel Certificates prior to seven days before the date scheduled for closing to confirm the tenants' acquiescence to the terms stated in the certificate. [See **RPI** Form 598; see Chapter 32]

11.8 *Tenant security:* **Requires** the seller to prepare and deliver a statement disclosing criminal activity affecting individuals on the property and any crime prevention undertaken or which should be undertaken. [See **RPI** Form 321; see Chapter 20]

11.9 *Due diligence contingencies:* **Check** the box to indicate the due diligence contingencies addendum for additional conditions is attached. [See **RPI** Form 279]

Condition and property

12. **Property Conditions:**

12.1 *Seller to furnish:* **Check** the appropriate box(es) within the following subsections to indicate the items the seller is to furnish prior to closing.

a. *Pest control:* **Check** the box to indicate the seller is to furnish a structural pest control report and clearance.

b. *Home inspection report:* **Check** the box to indicate the seller is to employ a home inspection company and furnish the buyer with the company's home inspection report.

c. *Home warranty:* **Check** the box to indicate the seller is to furnish an insurance policy for home repairs. **Enter** the name of the insurer and the type of coverage, such as for the air conditioning unit, etc.

d. *Local ordinance compliance:* **Check** the box to indicate the seller is to furnish a certificate of occupancy or other clearance required by local ordinance.

e. *Energy Audit Report:* **Check** the box and **enter** the rating of the property's improvements. [See Chapter 8]

f. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

12.2 *Safety compliance:* **Requires** smoke detectors and water heater bracing to exist or be installed by the seller.

12.3 *Property maintenance:* **Requires** the seller to maintain the present condition of the property until the close of escrow.

12.4 *Fixtures and fittings:* **Confirms** this agreement includes real estate fixtures and fittings as part of the property purchased.

Editor's note — Trade fixtures are personal property to be listed as items on an attached inventory at §1.

12.5 *Leasing and lease modifications:* **Requires** the seller to obtain

Condition and property, cont'd

the buyer's consent (which will not be unreasonably withheld) to any new tenancies or modifications of existing tenancies entered into during the escrow period.

13. **Closing conditions:**

13.1 *Escrow closing agent:* **Enter** the name of the escrow company handling the closing.

a. *Escrow instructions*: **Check** the box to indicate the purchase agreement is to also serve as the mutual instructions to escrow from the parties. The escrow company will typically prepare supplemental instructions they will need to handle and close the transaction. [See **RPI** Form 401]

b. *Escrow instructions*: **Check** the box to indicate escrow instructions have been prepared and are attached to this purchase agreement. **Attach** the prepared escrow instructions to the purchase agreement and **obtain** the signatures of the parties. [See **RPI** Form 401]

13.2 *Closing date:* **Enter** the specific date for closing or the number of days anticipated as necessary for the parties to perform and close escrow. Also, prior to seven days before closing, the parties are to deliver all documents needed by third parties to perform their services by the date scheduled for closing.

a. *Escrow charges*: **Requires** each party to pay their customary escrow closing charges, amounts any competent escrow officer can provide on inquiry. [See **RPI** Forms 310 and 311]

13.3 *Title insurance*: **Provides** for the title to be vested in the name of the buyer or their assignee. **Enter** the name of the title insurance company which is to provide a preliminary title report in anticipation of issuing title insurance. **Check** the appropriate box to indicate the type of title insurance policy to be issued.

a. *Policy endorsements*: **Enter** any endorsements to be issued with the policy.

b. *Payment of premium*: **Check** the appropriate box to indicate whether the buyer or seller is to pay the title insurance premium.

13.4 *Fire insurance:* **Requires** the buyer to provide a new policy of hazard insurance.

13.5 *Prorates and adjustments:* **Authorizes** prorations and adjustments on the close of escrow for taxes, insurance premiums, rents, interest, mortgage balances, service contracts and other property operating expenses, prepaid or accrued.

a. *Supplemental property tax:* **Check** the box to indicate a notice of supplemental property tax bill has been prepared and attached. [See **RPI** Form 317]

13.6 *Personal property:* **Requires** the seller to execute a bill of sale for any personal property being transferred in this transaction at

Condition and property, cont'd

§1.

a. *Personal property report*: **Check** the box to indicate escrow is to order a UCC-3 from the Secretary of State on any personal property located on the real estate which is to be transferred by bill of sale to the buyer.

13.7 *Assignment of leases:* **Requires** the seller to assign all leases and rental agreements to the buyer on closing. [See **RPI** Form 595]

a. *Ownership notice:* **Requires** the seller to notify each tenant of the change of ownership. [See **RPI** Form 554]

13.8 *Tenant security deposits:* **Requires** the seller to credit or pay the buyer on the close of escrow for security deposits held by the seller under the existing occupancies. **Requires** the seller to notify each tenant of the transfer of the security deposit. [See **RPI** Form 586]

Editor's note — Proper notice to the tenant regarding the security deposit transfer to the buyer eliminates all future liability the seller may have had due to the seller's original receipt of the deposits.

13.9 *Rent due and unpaid at closing:* **Treats** delinquent unpaid rent as paid for purposes of prorations. The buyer is credited for their share of paid and unpaid rents for the month of the closing. On any later recovery by the buyer of delinquent prorated rent, the buyer is to forward the entire amount received to the seller.

13.10 *Service contracts:* **Enter** the name of the providers of services under contracts the buyer is to assume.

a. *Prorations*: **Authorizes** the proration of amounts prepaid or unpaid on the service contracts.

13.11 *Buyer's possession:* **Requires** the seller to deliver possession of the property to the buyer on the close of escrow.

13.12 *Property destruction:* **Provides** for the seller to bear the *risk of loss* for any casualty losses suffered by the property prior to the close of escrow. Thus, the buyer may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage.

14. *Supplemental property tax bill*: **Notifies** the buyer they will receive one or two supplemental property tax bills they are to pay when the county assessor revalues the property after a change in ownership.

Structuring the broker fee

15. **Broker fee:**

15.1 *Fee amount:* **Enter** the total amount of the fee due all brokers to be paid by the seller. The amount of the fee may be stated as a fixed dollar amount or as a percentage of the price.

a. *Seller paid:* **Provides** that the seller will pay the broker fee on the change of ownership.

b. *Wrongful prevention:* **Provides** that the party wrongfully preventing the change of ownership will pay the broker fee.

Editor's note — The defaulting party pays all broker fees and the broker fee can only be altered or cancelled by mutual instructions from the buyer and seller.

15.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive or **check** the box if a separate Fee Sharing Agreement is attached. [See **RPI** Form 105]

Editor's note — The percentage share may be set based on an oral agreement between the brokers, by acceptance of the listing broker's MLS offer to a buyer's broker to share a fee, or unilaterally by the buyer's agent when preparing the buyer's offer.

15.3 *Agency law disclosures:* **Check** the box to indicate a copy of the Agency Law Disclosure addendum for all parties to sign is attached. The disclosure is mandated to be acknowledged by the buyer with the offer and acknowledged by the seller on acceptance as a prerequisite to the buyer's broker enforcing collection of the fee earned on all property transactions other than multi-family parcels with more than four units. [See **RPI** Form 305]

15.4 *Disclosure of sales data:* **Authorizes** the brokers to report the transaction to trade associations or listing services.

16. *Other terms:* **Enter** any special provision to be included in the purchase agreement.

Agency confirmation

Buyer's broker identification: **Enter** the name of the buyer's broker and their California Department of Real Estate (DRE) license number. **Enter** the name of any buyer's agent and their DRE license number. **Obtain** the signature of the buyer's broker or agent acting on behalf of the buyer's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and their agents') conduct with the parties. **Enter** the buyer's broker's address, telephone and fax numbers, and email address.

Seller's broker identification: **Enter** the name of the seller's broker and their DRE license number. **Enter** the name of any listing agent and their DRE license. **Obtain** the signature of the seller's broker or the listing agent acting on behalf of the seller's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and their agents') conduct with the parties. **Enter** the seller's broker's address, telephone and fax numbers, and email address.

Signatures

Buyer's signature: If *additional* buyers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the purchase agreement and the buyer's name. **Obtain** the buyer's signature.

Seller's signature: If *additional* sellers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the purchase agreement and the seller's name. **Obtain** the seller's signature.

Rejection of offer

If the offer contained in the purchase agreement is rejected, and the rejection will not result in a counteroffer, enter the date of the rejection and the names of the party rejecting the offer. Obtain the signatures of the party rejecting the offer.

Observations

As a policy of the publisher to provide users of **RPI** forms with maximum loss reduction protection, this purchase agreement does not contain clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker. Excluded provisions include:

- an *attorney fee provision*, which tends to **promote litigation** and inhibit normal contracting;
- a *time-essence clause*, since future performance (closing) dates are, at best, estimates by the broker and their agents of the time needed to close and are too often **improperly used** by sellers in rising markets to cancel the transaction before the buyer or broker can reasonably comply with the terms of the purchase agreement;
- an *arbitration provision*, since arbitration decisions are **final and unappealable**, without any assurance the arbitrator's award will be fair or correct; and
- a *liquidated damages provision*, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable.

Chapter 7 Summary

An agent seeking an income property for a client first reviews an Annual Property Operating Data sheet (APOD) to assess the property's suitability to the client. If the property meets the buyer's requirements, the agent requests more information about the property, including:

- a rent roll spread sheet;
- an occupancy history of each unit;
- information on security arrangements and criminal activity;
- an interview with a property manager;
- information on maintenance and repair services;
- CC&R exclusions to the title insurance policy; and
- any other material facts about the property's condition or location which may affect its value.

Price negotiations are best to commenced only when disclosures of all readily available property data and information have been handed over by the seller or the seller's agent.

After receiving the disclosures and conducting a minimal investigation, the buyer's agent prepares a purchase offer agreement. The seller and prospective buyer establish conditions to be met so the prospective buyer can complete a due diligence investigation and confirm their initial expectations about the property.

The income property purchase agreement becomes the binding written contract between the buyer and seller. A comprehensive income property purchase agreement includes:

- identification of the buyer, seller and property;
- the price and financing terms of the sale;
- agreements setting forth the terms of acceptance and performance of the contract, including deadlines and cancellation provisions;
- due diligence contingencies for the buyer's investigation;
- the buyer's confirmation of the property conditions as disclosed;
- closing conditions and procedures;
- brokerage and agency provisions, such as the amount and payment of the broker fee and confirmations of agency; and
- the binding signatures.

Chapter 7 Key Terms

Chapter 8

A property's energy demands: an evolving factor in marketing

Learning Objectives

After reading this chapter, you will be able to:

- calculate the financial consequences of a property's energy consumption;
- recognize why energy efficiency will increasingly affect the pricing of a home;
- understand how to quantify savings on operating costs for an energy efficient home; and
- implement strategies for marketing an energy efficient home.

Key Terms

operating expenses

The greener future is at hand

Buyers and sellers of real estate are fast becoming aware that a household is a heavy consumer of electricity, gas and other fuel sources.

Utility bills have in the past been given and are still given the silent treatment by agents, yet every seller knows well the amounts paid. Utility expenses are a significant cost factor incurred to carry the operating expense of owning a home.

More than just the daily management of turning off unused lights or running the sprinklers fewer times a week, the way a home is built has a drastic impact on how much energy it consumes, and thus the size of utility bills.

The existence and cost of utilities consumed by a home are **material facts** a prospective buyer needs sufficient information about to consider homeownership, and one home over another. It might just engender negotiations, or send the prospective buyer away, which is why the utility costs are material and are disclosed.

Most owners do not presently realize the actual structure of a home has a positive or negative impact on the monthly cost of their energy consumption. However, buyers are becoming more aware of these impacts and sellers will feel the effect of energy efficiencies on the pricing of their home.

Energy efficiency is a public policy trend

Living a "green" lifestyle is a concept now permeating the American psyche for more reasons than a reduction in utility bills. Public policy, social media and evolving general environmental culture all encourage individuals to make eco-friendly lifestyle choices.

The need for renewable resources has become main stream thinking for reasons of science, not implicit beliefs, and this creates an enduring *demand* for efficient homes. The idea of renewables also plays a significant role in the training of real estate agents and education of homebuyers. The visionaries advocating environmental sustainability — builders and brokers — are looking at a shift in buyer decision making as a nod toward their demand for energy efficient new and used home in the future.

California energy consumption

In today's *post-Millennium-Boom* culture, homeowners are receptive to living more efficiently. Cutting living costs, deleveraging out of debt and building up savings have become acceptable family financial planning solutions following the Great Recession.

However, in their quest many owners and buyers are not aware of the government programs sponsoring and subsidizing energy efficiency to encourage smarter consumption. Forward looking brokers and agents will do a bit of professional homework and inform their buyers and sellers about the subsidies and grants available to renovate a home to improve its energy rating.

To put the concept to work, the federal government has developed Home Energy Score programs designed to:

- encourage homeowners to make their homes more energy-conscious; and
- motivate homebuyers to buy homes in locations and with improvements that consume less energy.

The federal **home energy score** is a rating assigned to each home by an energy specialist. Using this rating system, buyers can determine how much energy the home and its occupants expend due to its current physical condition and location in a community.

Homes with a high energy score require the expenditure of a large amount of energy brought on in part by the need to commute to work or convenient amenities. Conversely, homes with low scores are more energy efficient and better located for access to schools, services and jobs. For homeowners and sellers, the specialist will suggest changes to the structure to improve the score.

Builders also are motivated to construct homes with the home energy score in mind. They will be better able to compete with *multiple listing service (MLS)* resale agents. Agents do need to advise sellers to consider spending money on renovations if they are to drop their energy score to compete with new home sales.

The influence of agents on energy efficiency

Presently, very few homebuyers are advised by their agent to consider the energy efficiency of a home when deciding to purchase one. Energy disclosures are material aspects of a home since energy consumption data affects decisions about the *carrying costs* of owning one property or another.

All agents have a duty owed to prospective buyers to disclose known and knowable utility costs and energy efficiency data on a home before a price is set for a purchase. Operating costs are conditions of the property in the sales transaction they are negotiating.

A forward-thinking MLS agent will see these coming shifts in disclosures of property data and consumer thinking as an opportunity to label themselves as an expert in energy-efficient homeownership.

operating expenses
The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

What do buyers want?

Buyers are motivated to purchase energy-efficient homes for two reasons. The first, and easiest to quantify, is the savings on **operating costs**.

Second, the **social motivation** present in energy efficiency (mostly in high-tier communities) gives a homeowner green bragging rights. Since most home sales involve mid- and low-tier housing, we will focus on the *operating cost motivation* in decision making.

Strategies for making energy efficient improvements

When installing any home improvement, the homeowner needs to ask themselves: why am I doing this? In other words:

- Is this improvement going to increase their use and enjoyment of their residence now?; and
- Is the improvement going to increase the value of their home when they sell?

The vast majority of energy-efficient improvements will increase the home's value to some extent, while also allowing the homeowner to save money on utility costs over several years. However, there are some notable exceptions.

First, leasing solar panels can prove tricky when the homeowner decides to sell. Most solar operators that provide solar leases are eager to transfer their service (but not ownership of the equipment) over to the buyer of a home subject to the existing lease. (More accurately, the solar company is leasing the roof area to place their electrical generating equipment so they can sell to the local utility the surplus electricity not used by the homeowner.)

But what if the homebuyer doesn't want any part of a solar lease obligation and its encumbrance on title? There are several options, but – as experience has taught many agents – solar lease encumbrances can prove to be an obstacle when trying to close a deal.

Second, any energy-efficient improvements that are owned and part of the real estate (not a solar lease situation) need to be installed for a number of months or years before the homeowner's investment will begin paying off. The inverse is also true: if an energy-saving improvement is owned and has been installed for too long, it becomes outdated and obsolete. It can actually lower the value of the home.

Thus, timing and the ownership of the solar equipment is significant.

Strategies when selling

When your seller client has made energy efficient improvements (unless they fall under the exceptions listed just above) then you are in luck. *Green homes* are in high demand.

However, you need to let potential buyers know about the energy-saving improvements through your marketing efforts. To best do this, ask your seller to authorize you to order an *energy audit*. Then advertise this green condition when marketing the property to locate a buyer. Provide it to prospective homebuyers at an open house when negotiations begin – on their further inquiry into the property as a prospective buyer.

When your seller refuses to order a full energy audit, ask for cost-of-utilities information. With the data, prepare a cost-comparison sheet so buyers can compare the utility cost of your seller's energy-efficient home with a similar energy-inefficient home down the block. Circle the monthly savings to bring it to the attention of potential buyers as justification for paying a higher purchase price. Prospective buyers who think green will be more likely pay top dollar. [See **RPI** Form 150, §11.h]

Listing an energy efficient home

When given the opportunity to list a home with energy-efficient features, *proper marketing* is helpful to more effectively locate a buyer who is willing to pay the listed price for the property. Curiosity also stimulates the mines of those buyers not up to speed on efficient homes to inquire further. On learning, they will likely be more interested as energy efficiency has to do with money.

Seller's agents need to demonstrate how the listed home stands out over other homes on the market. Essentially, how is the home *uniquely different* from the pack of other homes for sale in the area? The home's neighborhood is pivotal, as every home in a neighborhood is going to trend toward an average price per square foot.

The marketing task of the seller's agent is to communicate to potential buyers that the energy-efficient home is actually a better deal than comparable

	Without Energy Improvements	With Energy Improvements
Home Price	$150,000	$154,816
Mortgage Amount	$135,000	$139,334
Monthly Payment	$991	$1,023
Energy Bills	$186	$93
Energy Bills + Monthly Payment	$1,177	$1,116
Monthly Savings	$0	$61
Savings over a ten-year period	$0	$7,320

**Numbers from the Department of Housing and Urban Development (HUD's) Energy-Efficient. Mortgage Home Owner Guide.*

Figure 1

Sample buyer operating cost sheet

homes lacking energy efficiency. To best accomplish this, a cost *analysis worksheet* is prepared, itemizing data on the seller's monthly operating expenses a buyer will likely experience as owner of the property.

Comparing investments

Buying a home for most families is an emotional event. However, cost data on a worksheet speaks louder than feelings. Buyers who are well-informed about the conditions of a property by the seller's agent feel comfortable that they are getting the most for their money. [See Figure 1]

Communicate the savings to potential buyers by comparing the *operating costs* of an energy-efficient home with that non-energy-efficient home down the street. This will show the buyer exactly how much they will save in ownership costs each month. An alert agent will further demonstrate the long-term savings the buyer will receive over the years. [See **RPI** Form 306]

An *operating cost sheet*, together with a comparable market analysis presentation, demonstrates a more expensive house with the right energy features pays off in savings over the long run. [See **RPI** Form 318]

A little effort is required of the seller's agent and the seller to gather the utility cost data on the listed property. With the help of the utility company, an agent can determine the monthly energy savings for energy upgrades. Presently, much effort working with other agents is required to get them to release the utility costs incurred by comparable properties on the market which do not have energy-efficient improvements.

The seller's agent needs to encourage the seller to give them authorization to order out a home *energy audit* from a Home Energy Rater certified by the Department of Energy.

Check out the fees charged by home energy raters. Be prepared to show the seller how they can help you assemble a comprehensive marketing package on the property.

Making it easy

The goal of the seller's agent is to make the home buying process simple. Often, seller's agents throw up their hands when dealing with inquiries from buyers and buyer's agents, saying, "It's not standard practice for the seller's agent to get you this information." That buyer is heading out the door and down the street. They will find another house offered by an agent who has done their homework – more buyer-friendly – and has the information in printed form to hand to them.

Further, first-time Generation Y (Gen Y) homebuyers will certainly look for an agent who knows every option available. One who will provide them with an informed, clearly stated opinion about operating costs.

But what if the listed home is anything but energy-efficient – complete with minimal insulation, behemoth water heater and drafty windows?

Marketing the fixer-upper

You may have seen the TV show: a buyer visits multiple run-down listings with an agent and contractor in tow. The contractor informs the buyer how much improvements would cost, and what can be improved within their budget.

However, most buyers cannot afford to hire a contractor to accompany them to each house they're interested in. Further, seller's agents typically fail to invest time researching their listed property's energy efficiency and buyer's agents are not in a position to do so beyond asking for the information.

Seller's agents of properties with built up *deferred maintenance* to be eliminated need to understand that they have legwork to do. By working with a contractor to find out how much it will cost to install energy-efficient improvements, the seller's agent takes the guesswork about the property out of the equation for buyers and their agents – work done on behalf of the seller, the client.

The cost of energy-efficient improvements offers a higher rate of return than other, more cosmetic improvements. Thus, buyers can feel comfortable about installing suggested improvements.

Editor's note — In California, solar panels owned and operated by the homeowner create on average a 97% return on investment through an increase in property value after accounting for federal and state subsidies. This is in addition to the actual energy costs saved each month.

Chapter 8 Summary

The existence and cost of utilities consumed by a home are material facts a prospective buyer needs sufficient information about to consider homeownership, and one home over another. It might just engender negotiations, or send the prospective buyer away, which is why the utility costs are material and are disclosed.

The vast majority of energy-efficient improvements will increase the home's value to some extent, while also allowing the homeowner to save money on utility costs over several years.

When your seller client has made energy efficient improvements you are in luck. Green homes are in high demand. However, you need to let potential buyers know about the energy-saving improvements through your marketing efforts.

The cost of energy-efficient improvements offers a higher rate of return than other, more cosmetic improvements. Thus, buyers can feel comfortable about installing suggested improvements.

Chapter 8 Key Terms

operating expenses .... pg. 67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Chapter 9

Income property analysis for investor review

Learning Objectives

After reading this chapter, you will be able to:

- understand the methods and procedures an income property broker employs to gather operating data from the seller;
- comprehensibly compile property data into a persuasive marketing package you present to prospective buyers for their review to determine the property's suitability for investment; and
- understand the components and function of the various property data sheets included in a marketing package, the presentation of an income property's fundamentals for a buyer's analysis.

Key Terms

capitalization (cap) rate	**marketing package**
investor	**net operating income (NOI)**
letter of intent (LOI)	**speculator**

Marketing homework for a positive investor response

A seller's agent's objective is to locate a buyer to acquire a property they market for sale. The moment a prospective income property buyer comes forward, the seller's agent needs to be able to hand them **marketing information** relevant to the property's value in a package that cohesively lays out:

- the physical attributes and condition of the property;
- the property's location, zoning and uses permitted; and
- the current, and if feasible, anticipated annual operating figures for the property.

While many potential income property investors will likely respond to the agent's marketing efforts, very few will earnestly consider acquiring the property beyond a fleeting moment glancing at information and data packaged and delivered.

For these brief encounters, a seller's agent can methodically increase the odds of retaining a buyer's attention and receiving an earnest proposal by giving the property life in a **marketing package** brimming with all the details on its:

marketing package
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

- current profit and loss (P&L) for operations;
- physical condition; and
- location.

An attractive package, unquestionably sufficient to fully inform a prudent investor, automatically triggers their setting a price they might value the property for acquisition.

A thorough *marketing package* is built by compiling property operating data in combination with other critical property disclosures. [See the **Income Property Brokerage (IPB)** suite of forms; see Chapter 10]

Behavior forged by buyer motivation

Buyers come in two basic classifications:

- **investors** and **end users**; or
- **speculators**.

Also, buyers tend to appear at different stages in a business cycle, from boom to bust and back.

investor
A purchaser who holds a property long-term on a buy-to-let basis as an income producing investment. Contrast with a speculator who buys a property to flip it for profit on a sale, rather than earn annual income from continued ownership.

Investors and end users purchase property for the income potential or rent to be saved over the long haul of an ownership. They generally surface at the end of recessions, the early part of a recovery when property owners and tenants appear to be stabilizing from the disruption of a recent recession.

For investors and users, the marketing package with its income and expense analysis section is the evidence they need of the property's inherent fundamentals — support for a future flow of income or utility.

On the other hand, *speculators* acquire real estate for the profit it yields on a quick resale. Here, existing tenants on leases at current rents are a detriment.

speculator
A real estate investor who owns property short-term, sandwiching themselves between the seller and end user of the property.

Speculators do not venture into the basic calculus of income, expenses, capitalization rates (cap rates), mortgage rates or tenant turnover to determine value. [See Chapter 4]

When they do enter the market, they come in abundance and buy with near abandon, either:

- at the bottom of the market in the depths of a recession (to fill their portfolio with assets on the cheap); or

- in a boom when sales volume momentum is dramatically driving prices up (to ride a price tsunami for a quick flip without concern for any sort of valuation analysis).

Thus, with speculators, the marketing package becomes an imperative *line of defense* for a seller's agent against a speculator's gamble ending in a loss on a resale. Triggered by losses on a resale, speculators make claims on the seller's agent for recovery of losses incurred due to nondisclosures.

capitalization (cap) rate
The annual rate of return on invested capital based on net operating income (NOI) produced by the operations of an income property. The cap rate is calculated by dividing the NOI by the property's price.

Be mindful that the last speculators into the market before sales volume gives out and prices tumble take losses, or they simply retain the property, adjust their business model and wait out the current recessionary downside in pricing.

Either way, when dealing with a speculator, the seller's agent has an *increased risk of claims* compared to those associated with an investor. Unlike a speculator, a long-term property investor makes a studied purchase decision based on data the seller's agent produced in a package replete with the seller's agent's due diligence observations and findings.

Marketing package as catalyst

For investors, data presented in a marketing package is used to set the rate of return — the **capitalization (cap) rate** — justified based on the property fundamentals presented in the agent's package.

As always, a *cap rate* comprises the rate of consumer inflation foreseen by the investor, an annual risk-free and management-free profit margin on capital invested, plus a premium rate for risks of ownership unique to the property (as disclosed by the marketing package). [See Chapter 4]

net operating income (NOI)
The net revenue generated by an investment property before mortgage payments. It is calculated as the sum of a property's gross operating income less the property's total operating expenses. [See **RPI** Form 352 §4]

When an investor sets their cap rate for a particular property, the optimal price to offer for the property is quickly determined by dividing the **net operating income (NOI)** by the investor's annual cap rate.

Thus, the formula is simply:

NOI/cap rate = price

Data critical to the investor's analysis, in one place

It is well known that buyers of income property need data to act upon — no data, no action. However, far too many sellers' agents tend to merely present their pro forma conclusions about the property's operations, then move on to a friendly discussion about their listing, the marketplace and the current seller's issues.

A good marketing package avoids loose talk — it presents the property in a self-explanatory format, full of data and information quickly digestible by potential buyers.

Thus, the package functions as a full up-front operating and property disclosure. When promptly delivered on an inquiry into the property, the marketing package allows a buyer and their agent to quickly form their own conclusions on whether the property's historical performance meets their standards and investment objectives. If so, the yield they need on this class of investment opportunity —the cap rate — is quickly used to set the price they are willing to pay. [See the **Income Property Brokerage (IPB)** suite of forms; see Chapter 10]

Without operating data, the buyer is simply unable to set an informed price to be offered for a property — they are flying blind in the murky clouds of abstraction.

Data the buyer's agent needs

When a seller's agent has an income property listing and provides insufficient data on the property's operations on inquiry from a buyer's agent, the next step for that buyer's agent is to prepare and submit a **letter of intent (LOI)**, not an offer to purchase. [See **RPI** Form 185 and 186]

letter of intent (LOI)
A non-binding proposal signed and submitted to a property owner to start negotiations to rent or buy a property. [See **RPI** Form 185]

Part of the *LOI* (which may or may not contain a price) is a demand for property operating data.

To encourage proper compliance with the request for information, the buyer's agent hands the seller's agent blank copies of the relevant property operations forms for the seller and the seller's agent to prepare. This ensures no misunderstanding exists about the type of data the buyer expects the seller and the seller's agent to deliver.

Until the information is provided by the seller's agent, the buyer's agent is unlikely to proceed with further negotiations after submitting an LOI. Without property operating data, the price cannot be set and the risks of ownership inherent in the property cannot be determined.

Editor's note — When property data is delivered, it needs to include written assurance the seller (if not someone else) is the source of the data, not just the common but useless statement that an unidentified source was deemed reliable.

When the seller's agent does not have a marketing package, or some other method of delivering operating data and property information on an inquiry into further information on a listed property, it is likely the buyer's agent was the first agent with a buyer to express interest in the property. Had a prior "truly" interested buyer existed, or had a previous LOI been submitted on the property, the seller's agent would already have the property's operating data available, presentable in some fashion.

Such behavior is civilly negligent marketing by the seller's agent. It is both unproductive and unprofessional as it poses a risk for everyone who chooses to get involved.

The dilemma of the buyer's agent: getting information

While the buyer's agent depends upon the seller's agent to compile a large amount of data, both the seller's and buyer's agents must learn to cope with the caprice of the seller.

The seller's agent's practical problem is a simple issue of demanding the seller produce the requisite details they have readily available about the property's operations. When the seller is uncooperative or obstructive, the seller's agent cannot just conjure up a rent roll or pull scheduled income and expense amounts out of the phone book. A "source" for the data they use is necessary to shift liabilities for inaccuracies from the seller's agent and to induce buyers to acquire the property.

When the seller's agent does not give their source for data, the seller's agent presenting the inaccurate information is **intentionally misrepresenting** facts which are readily available to them via the seller.

Each property is unique in its ability to generate rental income, and the expenses of each are different from any comparable property on the market — often dramatically so. It is the seller, if they have the desire to sell, who needs to be forthcoming with the operating data. Without it, it is unclear just what they are selling, if not a *pig in a poke*.

Sellers have the needed information readily available to them, and their failure to release this information to buyers upon request is equivalent to *intentional deceit* if negotiations continue.

Working with your seller to get property information

The seller's agent's first effort to pull **operating data** on the property is made at the time the listing employment is negotiated with the seller. [See **RPI** Form 352 and 352-1; see Chapter 16]

Using the itemized data in the seller's operating statement, the agent fills out the marketing forms to be presented to prospective investor buyers.

When the seller fails to honor the agent's request for the seller's operating statement on the property, the seller's agent's only prudent alternative is to:

- hand the seller the relevant forms the agent would fill out for the marketing package; and
- kindly request the seller fill them out for the agent's use in delivering an operating profile on the property to prospective buyers.

When, at this point, the necessary information is still not forthcoming and the seller has entered into a listing agreement, the seller is in breach of their good faith obligation to cooperate fully with the seller's agent as the person they employed to market the property.

Further, the agent's fee under the listing has been earned and is immediately due for the seller's failure to provide information needed by the agent to accomplish the stated goal of his employment – the sale of the property.

At the listing stage, the agent is not to take the listing unless the seller provides or agrees to provide marketing data on the property. Failure to willingly release the property's operating information indicates a duplicitous desire of the seller to hide known information from prospective buyers. [See **RPI** Form 352 and 352-1]

The marketing package: style is substance

A seller's agent handing out information on a property has:

- three seconds to attract attention to their listing;
- 30 seconds to hold that attention, and then, if the viewer is still interested;
- three minutes to convince them that this is the property to buy.

This is sometimes termed the **3 + 30 + 3 Rule**.

The opportunity to harness the attention of an actual buyer happens quickly or not at all.

It is beneficial to think of the marketing package as a star salesman: silently performing magic on those very few that actually buy, finding the ideal taker of the listed property and enticing them to acquire it.

A seller's agent's time, effort and talent need to be spent assembling an excellent marketing package before the potential buyer ever encounters the property as available to acquire.

When the package is prepared with information furnished by the seller, it is then handed to a prospective buyer. At that moment, it becomes the buyer's first and most lasting impression of the listed property.

A thorough marketing package promptly handed to prospective buyers on first inquiry into the property assures the agents involved that they have the best chance of retaining an interested buyer's attention throughout negotiations — and on to closing escrow.

The 3+30+3 Rule in practice

Brokers and agents keen to understand the *3 + 30 + 3* real estate sales formula for income property brokerage will:

- take the time needed to package their listing for sale and dress up their marketing package as the most capable and best-informed "sales representative" they have for the job;
- gather all relevant income and expense data and related operating information, and enter it on **Income Property Brokerage (IPB)** suite of forms to present all the necessary data in a compelling package;
- demonstrate the personal characteristics needed to do their homework up front before presenting the property for examination by the very, very few serious prospective buyers this property will likely be the perfect fit;
- kindly ask prospective buyers and their agents to submit an offer, now that the seller's agent has fully performed their duties owed to the seller to make the property so transparent to buyers that nothing substantive remains to be discussed or later discovered about its income and expenses that is not disclosed in the package; and
- include disclosures about the property's *physical condition, title* and *natural and environmental hazards* on or about the property.

It is of utmost importance that income property listed for sale stand out above the noise created by other listings and marketing packages, whether online, on paper or on the street. The package needs to be memorable as a standout package and indicate the property marketed is the perfect fit for someone – when its measurements are made known. [See the **Income Property Brokerage (IPB)** suite of forms; see Chapter 10]

Delivering the data

The format and spreadsheets essential to the creation of a marketing package for income property exist in the **RPI (Realty Publications, Inc.) Income Property Brokerage (IPB) suite of forms**. To be assured no pertinent aspect for setting value and pricing is overlooked, the *IPB* package is a checklist providing the buyer with information reflecting the due diligence talent of the agent who prepared it.

Editor's note — The entirety of the IPB suite of forms is presented in the next chapter. [See Chapter 10]

IPB forms

The IPB package is comprised of several forms. Together, they present the fundamentals for buyer analysis of an income property. Preparation of the IPB package begins with the seller's agent's completion of the preliminary **Work-Up Sheet Template**, used to enter approximations of recurring amounts. Data entered in the *Work-Up Sheet Template* automatically fills in corresponding fields in all the IPB forms.

When using the forms, entries on the Work-Up Sheet Template are automatically overridden with more accurate figures when detailed data is entered or calculated in other forms.

Further, as the different IPB forms are filled out in detail, prior figures are automatically recalculated and updated. The Work-Up Sheet Template is for the agent's approximations before getting into details. It is not intended to be a page included in the package handed to the seller or the buyer.

The multiple forms which make up the IPB package for buyer analysis include:

- a **Transmittal Cover Letter** requesting the investor's consideration of the property as an investment opportunity;
- the **Property Location/Zoning**, to include property pictures, maps and uses permitted [See the **Income Property Brokerage (IPB)** suite Form 1; see Chapter 10];
- the **Property Improvements**, including physical attributes, systems and amenities [See the **Income Property Brokerage (IPB)** suite Form 2; see Chapter 10];
- a **Financial Summary** showing the buyer's annual return from ownership and percentage return on cash invested [See the **Income Property Brokerage (IPB)** suite Form 3; see Chapter 10];

Sidebar

IPB suite of forms

The entire IPB suite of forms is available to all at no charge at ***www.realtypublications.com/forms***

- the **Price and Terms** including the property's fair market value (FMV) and GRM figure [See the **Income Property Brokerage (IPB)** suite Form 4; see Chapter 10];
- the **Loan Arrangements/Transactional Costs** [See the **Income Property Brokerage (IPB)** suite form 4-1; see Chapter 10];
- the **Annual Property Operating Data (APOD)** figures displaying the property's gross operating income, expenses, NOI and spendable income [See the **Income Property Brokerage (IPB)** suite Form 5; see Chapter 10];
- the **Income Tax Aspects** estimating the investor's reportable income (or loss) and net annual after-tax cash flow [See the **Income Property Brokerage (IPB)** suite Form 6; see Chapter 10];
- the **Rent Roll** displaying a multiple-tenant property's current or estimated monthly rental income by unit or space [See the **Income Property Brokerage (IPB)** suite Form 7; see Chapter 10];
- the **Annual Operating Expenses** as an itemized breakdown of the operating expenses the property is experiencing [See the **Income Property Brokerage (IPB)** suite Form 8; see Chapter 10]; and
- a **Disclosure of Providers** listing the source of servicers who now maintain the property. [See the **Income Property Brokerage (IPB)** suite form 9; see Chapter 10]

The **Financial Summary** page brings the critical data from all IPB forms together in a concise and easy to interpret summary. With it, the investor is presented with all the various financial calculations used to determine a property's value in one singular location in the series.

Further, to inform sellers and buyers about the significance of real estate terms used in the IPB forms, the seller's agent includes the IPB's **Glossary of Terms** in their final marketing package.

With that, welcome to the real world of IPB forms, the solution to your *3 + 30 + 3 marketing challenge*. [See Chapter 10]

Chapter 9 Summary

A seller's agent's objective is to locate a buyer to acquire a property they market for sale. The moment a prospective income property buyer comes forward, the seller's agent needs to be able to hand them marketing information relevant to the property's value in a package that cohesively lays out:

- the physical attributes and condition of the property;
- the property's location, zoning and uses permitted; and
- the current, and if feasible, anticipated annual operating figures for the property.

Buyers come in two basic classifications:

- investors and end users; or
- speculators.

For investors and users, the marketing package with its income and expense analysis section is the evidence they need of the property's inherent fundamentals — support for a future flow of income or utility.

Alternatively, speculators do not venture into the basic calculus of income, expenses and capitalization rates (cap rates) to determine value.

The seller is the source of information used in the marketing package. When they have the desire to sell, the seller needs to be forthcoming with the operating data. The seller's agent's first effort to get operating data on the property is made at the time the listing is negotiated with the seller. Using the itemized data in the seller's operating statement, the agent fills out the marketing forms to be presented to prospective buyers.

A seller's agent handing out marketing information on a property has:

- three seconds to attract attention to their listing;
- 30 seconds to hold that attention, and then, if the viewer is still interested;
- three minutes to convince them that this is the property to buy.

This is principle is referred to as the 3 + 30 + 3 Rule.

The format and spreadsheets essential to the creation of a marketing package for income property exist in the RPI (Realty Publications, Inc.) Income Property Brokerage (IPB) suite of forms. The IPB package is comprised of several forms. Together, they present the fundamentals for buyer analysis of an income property.

Chapter 9 Key Terms

capitalization (cap) rate .... **pg. 75**
investor .... **pg. 74**
letter of intent (LOI) .... **pg. 76**
marketing package .... **pg. 74**
net operating income (NOI) .... **pg. 75**
speculator .... **pg. 74**

Chapter 10

Income Property Brokerage (IPB) suite of forms

Learning Objectives

After reading this chapter, you will be able to:

- gather all relevant property income and expense data and related operating information in the Income Property Brokerage (IPB) suite of forms for investor review.

Editor's note — None of the material in this chapter will be covered in the quizzes or final exams for this course.

The following is a reproduction of core content of the ***RPI Income Property Brokerage (IPB)*** *suite of forms. The full suite contains additional support material, such as a glossary of terms and intructions.*

The IPB suite of forms is available to all at no charge at ***www.realtyoublications.com/forms***

For a discussion of the practical use of this suite of income property forms, see ***Chapter 9: Income property analysis for investor review****.*

Realty Publications, Inc. (RPI)

Income Property Brokerage (IPB) Package

Contents:

Instructions:

(See pages 20-27)

Complete and concise instructions for filing out each provision in every IPB form are located on pages 20-27. Generally, you start to prepare your IPB package by filling out the preliminary *Work-Up Sheet Template*. The data you enter in the *Workup* will automatically appear throughout the IPB forms in all the relevant provisions.

As you fill out the remaining IPB forms with more specific data, prior entries appearing in the forms will be recalculated and updated automatically to maintain accurate consistency.

IPB Form 3: Financial Summary brings the critical data from all IPB forms together in a summary which presents all the various financial calculations an investor might use to determine a property's suitability for his purposes.

To inform owners and buyers about the meaning of real estate terms used in the IPB forms, you may include the Glossary of Terms (pages 18-19) in your final marketing package.

For more information on an agent's use of IPB forms, see the **first tuesday** article, *Income property package; agent prepared, investor reviewed* on page 28.

Note: To print only particular forms or individual pages, not the full series, specify the range of pages to print in the ***print options*** *(for example, "4 - 6, 9 - 17").*

RPI
Income Property Brokerage (IPB) Forms

IPB: Work-Up Sheet Template

Broker ______________________	**Phone** ____________ **Fax** ______________
License # ______________________	**Email** ______________________________
Agent ______________________	**Date Prepared** _________________, **20**____
License # ______________________	**Prepared by** __________________________

1)	Property Location/ Zoning
2)	Property Improvements
3)	Financial Summary
4)	Price and Terms
4-1)	Loan Arrangements/ Transactional Costs
5)	APOD
6)	Income Tax Aspects
7)	Rent Roll
8)	Annual Operating Expenses
9)	Disclosure of Providers

This **Work-Up Sheet Template** is used by the agent completing the ***RPI*** *Income Property Brokerage (IPB)* package to enter approximations of recurring amounts. The date entered in the Work-Up Sheet Template will automatically fill in the corresponding fields in all IPB forms.

Estimated data entered here will be automatically overridden with data that is more correct once the correct figures are calculated by the program. Some fields already contain a default amount which may be overridden.

The Work-Up Sheet Template is used by the agent as a template for preparing his marketing package of IPB forms, and is not intended to be included in the package handed to the owner or the buyer.

All figures are estimates reflecting:

a. ☐ Current operating conditions.
b. ☐ Forecasts of anticipated operations (pro forma).
c. Source of Information: ____

1.	Asking Price	$____________	See Form 4
2.	Down Payment	$____________	
3.	Total Rentable Square ft.	____________	See Form 2
4.	Number of Units.	____________	
5.	Replacement Cost of Improvements..	$____________	
6.	Annual Percent Increase in Property Value.	2.0 %	See Form 3
7.	New Loan Amount	$____________	See Form 4-1
	a. Interest Rate	____________%	
	b. Monthly Payment . . . . (Online Calculator)	$____________	
	c. Loan Costs	$____________	
8.	Existing Loan Amount (Assumption)	$____________	
	a. Interest Rate	____________%	
	b. Monthly Payment	$____________	
9.	Carryback Note Amount	$____________	
	a. Interest Rate	____________%	
	b. Monthly Payment . . . . (Online Calculator)	$____________	
10.	Buyer's Transactional Costs	$____________	
11.	Scheduled Rental Income (Annual)	$____________	See Form 7
	a. Other Income (Annual)	$____________	See Form 5
12.	% Vacancies, Discounts, Non-Payment	5 %	
13.	Operating Expenses (Annual)	$____________	See Form 8
14.	Buyer's Tax Bracket	____________%	See Form 6

Dated: ____________________________, 20__________

To: ____

From: ____

Re: Investors with cash available for placement in an income-producing real estate investment program.

You are kindly requested to consider this investment opportunity.

The property to be acquired is a located at ____

City _____________________________, State _________________________ Zip __________

The asking price of this income property is $____________________.

Future ownership of this property will create the following advantages:

1. an initial capital investment without the expectation of future additional contributions;
2. minimal involvement by the investor;
3. spendable income distributed periodically;
4. equity buildup due to amortization of the loan amount through monthly payments paid from rental income;
5. an increase in value resulting from monetary inflation and asset appreciation; and
6. tax benefits provided by depreciation deductions and reinvestment on a sale of the property.

Please review the specially prepared Income Property Brokerage (IPB) report accompanying this letter for details and other advantages.

Please contact me through any of the methods below for any further property information you desire.

Sincerely,

____

Broker ______________________________________

DRE license # ______________________________

Agent ______________________________________

DRE license # ______________________________

Phone _________________ Fax _________________

Email ______________________________________

Realty Publications, Inc.

Work-Up Sheet Template

1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
4-1) Loan Arrangements/ Transactional Costs
5) APOD
6) Income Tax Aspects
7) Rent Roll
8) Annual Operating Expenses
9) Disclosure of Providers

RPI
Income Property Brokerage (IPB) Forms

IPB Form 1: Property Location/Zoning

Broker ______________________ Phone ____________ Fax ______________
License # ______________________ Email ______________________________
Agent ______________________ Date Prepared ________________, 20____
License # ______________________ Prepared by ________________________

All figures are estimates reflecting:

a. ☐ Current operating conditions.
b. ☐ Forecasts of anticipated operations.
c. Source of Information: ____

LOCATION:

Property Name: ____
Property Type: ____
Address: ____
City: ____
State: ____________________ **Zip:** ______________
Name of Community: ____
Property Pictures:
[Additional pictures, maps and supplementary figures ☐ are, ☐ are not attached.]

Location of Nearest:

Intersection: ____________________

Police Station: ____________________

Fire Station: ____________________

Bus/Metrolink Station: ____________________

Train Station: ____________________

Airport: ____________________

Local Housing Info:

Total Housing Units in __________ County: __________

Total Occupied Units: .... __________

Total Owner-Occupied: .... __________

Total Renter-Occupied: .... __________

Total Vacant: .... __________

Average Annual Household Income:

% Below $10,000 .... ________%

% $10,000 to $14,999 .... ________%

% $15,000 to $24,999 .... ________%

% $25,000 to $34,999 .... ________%

% $35,000 to $49,999 .... ________%

% $50,000 to $74,999 .... ________%

% $75,000 to $99,999 .... ________%

% $100,000 to $149,999 .... ________%

% $150,000 to $199,999 .... ________%

% $200,000 or more .... ________%

Local Population [__________ County]: __________

% Male, % Female: .... ________%, ... ________%

% 15 to 19 years: .... ________%

% 20 to 24 years: .... ________%

% 25 to 34 years: .... ________%

% 35 to 44 years: .... ________%

% 45 to 54 years: .... ________%

% 55 to 59 years:...________%

% 60 to 64 years:...________%

% 65 to 74 years:...________%

% 75 to 84 years:...________%

% Aged 85 and over: ....________%

Total Labor Force: ...._________

Total Non-farm Employment:..._________

Total Population ______ Years Ago:................................_________

Population Change over Past ______ Years: ....________%

ZONING:

Year Property was Built: _________

Present Use of Property:____

Highest and Best Use of Property: ______________________________________

Zone Type: ____

Uses Permitted: ____

____

Permissible Further Improvements: ______________________________________

Distance to a Change in Zoning:____

Proximate Zoning Type:____

Proximate Uses Permitted: ____

____

Attributes of Surrounding Area: [Enter text below]

Work-Up Sheet Template

1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
4-1) Loan Arrangements/ Transactional Costs
5) APOD
6) Income Tax Aspects
7) Rent Roll
8) Annual Operating Expenses
9) Disclosure of Providers

RPI
Income Property Brokerage (IPB) Forms

IPB Form 2: Property Improvements

Broker ______________________
License # ______________________
Agent ______________________
License # ______________________

Phone ____________ **Fax** ____________
Email ______________________
Date Prepared ______________, 20______
Prepared by ______________________

Property Type: ______________________
Location: ______________________

PROPERTY IMPROVEMENTS

1 Number of Units: ______________________
2 Unit Mix and Size: ______________________
3 Total Rentable Sq Ft: ______________________
4 Lot Size in Sq Ft: ______________________
5 Lot Dimensions: ______________________
6 Percentage of Ground Covered by Improvements: __________%
7 Total Cost to Replace All Improvements: $____________
8 Type of Construction: ______________________
9 Roof: ______________________
10 Plumbing: ______________________
11 Water Source and Lines: ______________________
12 Sewer Hookup: ______________________
13 Fire Sprinklers (type/rating): ______________________
14 Ceiling Clearance: ______________________
15 Electrical Supply: ______________________
16 HVAC Units: ______________________
17 Cable TV: ______________________
18 Internet: ______________________
19 Pool Dimensions: ______________________
20 Gym/Clubhouse Data: ______________________
21 Security Arrangements: ______________________
22 Elevator/Stairs: ______________________
23 Flooring: ______________________
24 Windows: ______________________
25 Number and Height of Ground Level Doors: ______________________
26 Number of Loading Docks: ______________________
27 Ramps: ______________________

PAGE ONE OF TWO — IPB FORM 2

— — — — PAGE TWO OF TWO — IPB FORM 2 — — — —

28 Parking Lot/Spaces on Unit: ______________________

29 Landscaping: ______________________

30 Fences: ______________________

31 Lighting Adequacy (Inside): ______________________

32 Lighting Adequacy (Outside): ______________________

33 Easement: ______________________

34 ____________: ______________________

35 ____________: ______________________

Work-Up Sheet Template
1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
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RPI
Income Property Brokerage (IPB) Forms

IPB Form 3: Financial Summary

Broker______________________________ **Phone** ______________ **Fax** _________________
License # ____________________________ **Email** ____________________________________
Agent _______________________________ **Date Prepared** _____________________, 20_____
License # ____________________________ **Prepared by** ______________________________

Property Type: ____
Location: ____

Annual figures are estimates reflecting:

☐ Current operating conditions.
☐ Forecasts of anticipated operations.

Financial Summary

1 Price-to-Rents Ratio (Gross Rents Multiplier (GRM)) . . . . _________
2 Price-to-Net Operating Income (NOI) Ratio (Net Income Multiplier (NIM)) . . . _________
2.1 Capitalization Rate . . . . _________%
3 Expenses to Gross Rents . . . . _________%
4 Mortgage Payments to Gross Rents . . . . _________%
4.1 Loan Reduction as Return on Cash ($__________) . . . . _________%
5 Cash-on-Cash Return (Spendable Income $__________) . . . . _________%
6 Annual Depreciation as a Percentage of Cash Invested . . . . _________%
7 Reportable Income . . . . (+ or -) $_________
8 Tax on Reportable Income. . . . . (+ or -) $_________
9 Cash Flow After Taxes. . . . .$_________
9.1 After-Tax Cash Flow as Return on Cash . . . . _________%
10 Price Per Square Foot of Rentable Improvements . . . . $_________
11 Price Per Unit or Space. . . . . $_________

Annual Return on Cash Invested

12 Loan Reduction as Return on Cash. . . . . _________%; $_________
13 After-Tax Cash Flow as Return on Cash . . . . _________%; $_________
14 Annual Percent Increase in Property Value (Anticipated) . . . . . _____2.0 %; $_________
15 Buyer's Total Return From Ownership . . . . $_________
15.1 Buyer's Annual Percent Return on Cash Invested . . . . _________%

Work-Up Sheet Template
1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
4-1) Loan Arrangements/ Transactional Costs
5) APOD
6) Income Tax Aspects
7) Rent Roll
8) Annual Operating Expenses
9) Disclosure of Providers

RPI
Income Property Brokerage (IPB) Forms

IPB Form 4: Price and Terms

Broker ______________________________ | Phone ______________ Fax _________________
License # ___________________________ | Email ______________________________________
Agent ______________________________ | Date Prepared ____________________, 20_____
License # ____________________________ | Prepared by ________________________________

Property Type: ____

Location: ____

PRICE:

Asking Price:..$__________

Gross Rent Multiplier (GRM): .... __________

Total Cost to Replace All Improvements:.....................$__________

Comparable Sales Price: ....$__________

Fair Market Value (FMV):..$__________

TERMS OF PAYMENT:

1. Down Payment:..$__________
2. New Loan Amount:..$__________
3. Assume Existing Loan:..$__________
4. Seller Carryback Financing: ....$__________
5. Buyer's Transactional and Loan Costs: ....$__________
6. Cost of Acquisition:...$__________

Work-Up Sheet Template

1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
4-1) Loan Arrangements/ Transactional Costs
5) APOD
6) Income Tax Aspects
7) Rent Roll
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9) Disclosure of Providers

RPI
Income Property Brokerage (IPB) Forms

IPB Form 4-1: Loan Arrangements/Transactional Costs

Broker ______________________ **Phone** ____________ **Fax** ____________
License # ______________________ **Email** ______________________
Agent ______________________ **Date Prepared** ______________, 20____
License # ______________________ **Prepared by** ______________________

Property Type: ____
Location: ____

All figures are estimates reflecting:

a. ☐ Current operating conditions.
b. ☐ Forecasts of anticipated operations.
c. Source of Information: ______________________________________

1. NEW LOAN ARRANGEMENTS: ☐ 1st ☐ 2nd

1.1 Lender's Name: ______________________________
1.2 Lender's Contact Information: ______________________________
____
1.3 Loan Type: ______________________________
1.4 Loan Amount:..$______________
1.5 Interest Rate: ....______%
1.6 Monthly Payment: ....$______________(Online Calculator)
1.7 Amortization Period (Months):..360 (mos.)
1.8 Loan Due Date: ....______________
1.9 Loan to Value (LTV): ....______%
1.10 Prepayment Penalty Expiration:..______________

2. EXISTING LOAN INFORMATION:

2.1 Lender's Name: ______________________________
2.2 Lender's Contact Information: ______________________________
____
2.3 Loan Type: ______________________________
2.4 Loan Amount:..$______________
2.5 Interest Rate: ....______%
2.6 Monthly Payment: ....$______________(Online Calculator)
2.7 Amortization Period (Months):..360 (mos.)
2.8 Loan Due Date: ....______________
2.9 Loan to Value (LTV): ....______%
2.10 Assumption Fee: ....$______________
2.11 Prepayment Penalty Expiration:..______________

3. CARRYBACK NOTE:

3.1 Note Amount:..$______________
3.2 Interest Rate: ....______%

— — — — PAGE TWO OF TWO — IPB FORM 4-1 — — — —

3.3 Monthly Payment: ....$______________(Online Calculator)

3.4 Amortization Period (Months):................................______360 (mos.)

3.5 Loan Due: ....______________

3.6 Loan to Value (LTV): ....______%

LOAN(S) COSTS:

1 Points/Discount . . . . $______________

2 Origination Fees. . . . . $______________

3 Loan(s) Escrow Fees . . . . $______________

4 Title Insurance Premium. . . . . $______________

5 **TOTAL Loan(s) Costs**. $______________

TRANSACTIONAL COSTS:

1 Anticipated Closing Date. . . . . ______________

2 City/County Fees . . . . $______________

3 Lender's Title Insurance Policy . . . . $______________

4 Title Policy Endorsements. . . . . $______________

5 Hazard Insurance Premium . . . . $______________

6 Property Survey Engineer. . . . . $______________

7 Prorated Property Tax . . . . $______________

8 Month-End Interest. . . . . $______________

9 Private Mortgage Insurance (PMI). . . . . $______________

10 Flood Certification . . . . $______________

11 Loan Document Preparation . . . . $______________

12 Escrow Fees and Charges . . . . $______________

13 Appraisal Fee . . . . $______________

14 Legal Fee for Closing . . . . $______________

15 Loan Origination Charges. . . . . $______________

16 Loan Points/Discount . . . . $______________

17 Investor Funding Fee . . . . $______________

18 Recording Fees . . . . $______________

19 Inspections and Reports. . . . . $______________

20 Tax Service . . . . $______________

21 Courier Fee . . . . $______________

22 Other Fee ______________________ . . . . . . $______________

23 [Non-itemized Approximate] . . . . $______________

24 **TOTAL Transactional Costs** . . . . $______________

IPB FORM 4-1 *(Loan Arrangements/Transactional Costs)* 12-13 ©2013

Work-Up Sheet Template
1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
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Income Property Brokerage (IPB) Forms

IPB Form 5: APOD (Annual)

Broker ______________________ Phone ____________ Fax ______________

License # ______________________ Email ______________________

Agent ______________________ Date Prepared ________________, 20____

License # ______________________ Prepared by ______________________

Property Type: ______________________

Location: ______________________

Annual figures are estimates reflecting:

a. ☐ Current operating conditions.

b. ☐ Forecasts of anticipated operations.

c. Source of Information: ______________________

Annual Property Operating Data (APOD)

1	Scheduled Rental Income	$________	100 %
1.1	Vacancies, Discounts and Non-Payments	$________	5 %
1.2	Effective Rental Income	$________	____%
1.3	Other Income	$________	____%
2	Gross Operating Income	$________	____%
3	Total Operating Expenses	$________	____%
4	Net Operating Income (NOI)	$________	____%
5	Mortgage Principal (in Payments)	$________	____%
5.1	Mortgage Interest (in Payments)	$________	____%
6	Spendable Income	$________	____%

IPB FORM 5 *(APOD)* 12-13 ©2013

Work-Up Sheet Template

1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
4-1) Loan Arrangements/ Transactional Costs
5) APOD
6) Income Tax Aspects
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9) Disclosure of Providers

RPI
Income Property Brokerage (IPB) Forms

IPB Form 6: Income Tax Aspects

Broker ______________________ **Phone** ____________ **Fax** ______________
License # ______________________ **Email** ______________________________
Agent ______________________ **Date Prepared** ________________, 20_____
License # ______________________ **Prepared by** ________________________

Property Type: ____
Location: ____

INCOME TAX DEDUCTIONS FROM NOI (ANNUAL):

1 NET OPERATING INCOME (NOI) ....$_____________
2 Annual Interest Accrued and Paid ....(-)$_____________
2.1 Prepaid Interest Accrued ....(-)$_____________
3 Cost Basis on Acquisition....................$_____________
3.1 % Value of Improvements ....75 %
3.2 Depreciable Cost Basis....................$_____________
3.3 Cost Recovery Period (In Years)........ ☐ 27.5 ☐ 39 ☑ 40
3.4 Annual Depreciation Deduction Allowance ....(-)$_____________
4 Reportable Income (or Loss) ....(+ or -)$_____________

AFTER-TAX CASH FLOW:

5 Spendable Income ....$_____________
6 Buyer's Tax Bracket ...._____________%
7 Income Tax Liability on Reportable Income/Loss .... (+ or -)$_____________
8 Net Annual After-Tax Cash Flow....................$_____________

Work-Up Sheet Template
1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
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5) APOD
6) Income Tax Aspects
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8) Annual Operating Expenses
9) Disclosure of Providers

RPI

Income Property Brokerage (IPB) Forms

IPB Form 7: Rent Roll

Broker ____________________ Phone ____________ Fax ____________

License # ____________________ Email ____________________

Agent ____________________ Date Prepared ________________, 20____

License # ____________________ Prepared by ____________________

Property Type: ____

Location: ____

<u>All figures are estimates reflecting</u>:

a. ☐ Current operating conditions.

b. ☐ Forecast of anticipated operations.

MONTHLY RENTAL INCOME

1 Unit or Space #	2 Rent Amount (monthly)	3 Rental Term	4 Date Tenancy Expires	5 Security Deposit and Prepaid Rent	6 Rent Incentives, Bonuses and Discounts	7 Delinquent Rent Amount
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$
	$			$		$

TOTALS: $__________ $__________ $__________

ANNUAL: $__________

Work-Up Sheet Template

RPI
Income Property Brokerage (IPB) Forms

IPB Form 8: Annual Operating Expenses

Broker ____________________________ **Phone** _______________ **Fax** _________________
License # __________________________ **Email** ____
Agent _____________________________ **Date Prepared** ____________________, 20________
License # __________________________ **Prepared by** ___________________________________

Property Type: ____
Location: ____

All figures are estimates reflecting:

a. ☐ Current operating conditions.
b. ☐ Forecasts of anticipated operations.
c. Source of Information: ____

ANNUAL OPERATING EXPENSES:

			%
1	Electricity	$______________	______%
2	Gas	$______________	______%
3	Water	$______________	______%
4	Rubbish	$______________	______%
5	Property Insurance	$______________	______%
6	Property Taxes	$______________	______%
7	HOA/Apt. Ownership Fees	$______________	______%
8	Property Management Fees	$______________	______%
9	Leasing Fees	$______________	______%
10	Resident Manager	$______________	______%
11	Worker's Compensation Insurance	$______________	______%
12	Office Expenses/Supplies	$______________	______%
13	Advertising/Screening Fees	$______________	______%
14	Lawn/Gardening	$______________	______%
15	Pool/Spa	$______________	______%
16	Janitorial/Cleaning	$______________	______%
17	Maintenance	$______________	______%
18	Repairs and Replacements	$______________	______%
19	CATV/Phone	$______________	______%
20	Accounting/Legal Fees	$______________	______%
21	Credit Card Charges	$______________	______%
22	Licenses/Rent Control Fees	$______________	______%
23	______________________	$______________	______%
24	[Non-itemized Approximate]	$______________	______%
25	**Total Operating Expense**	**$______________**	**______%**
26	Annual Inflation Adjustment ______2.0 %;	$______________	______%

Work-Up Sheet Template

1) Property Location/ Zoning
2) Property Improvements
3) Financial Summary
4) Price and Terms
4-1) Loan Arrangements/ Transactional Costs
5) APOD
6) Income Tax Aspects
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8) Annual Operating Expenses
9) Disclosure of Providers

RPI
Income Property Brokerage (IPB) Forms

IPB Form 9: Disclosure of Providers

Broker ______________________ | **Phone** __________ **Fax** ____________
License # ______________________ | **Email** ______________________
Agent ______________________ | **Date Prepared** ______________, **20**____
License # ______________________ | **Prepared by** ______________________

Property Type: ____
Location: ____

PROVIDERS:

1 Property Management: ______________________
2 Electricity: ______________________
3 Gas: ______________________
4 Water/Sewer: ______________________
5 Rubbish: ______________________
6 General Maintenance: ______________________
7 Janitorial/Cleaning: ______________________
8 Window Cleaner: ______________________
9 HOA/Apt. Ownership Services: ______________________
10 Property Insurance Carrier: ______________________
11 Phone/Electricity: ______________________
12 CATV Service: ______________________
13 Advertising: ______________________
14 Office Supplies: ______________________
15 Tenant Screening Service: ______________________
16 Painting: ______________________
17 AC and Heating: ______________________
18 Roofer: ______________________
19 Plumber: ______________________
20 Electrician: ______________________
21 Gardener: ______________________
22 Pool/Spa: ______________________
23 Parking Lot Maintenance: ______________________
24 Snow Removal: ______________________
25 Worker's Compensation Carrier: ______________________
26 Accountant: ______________________
27 Attorney: ______________________
28 ______________: ______________________
29 ______________: ______________________
30 ______________: ______________________

Chapter 11

Tenant leasehold improvements

Learning Objectives

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.

Key Terms

further-improvements provision

mandatory improvement

mechanic's lien

notice of nonresponsibility

permissive improvement

real estate fixture

reversion

tenant improvements

trade fixtures

Ownership rights when a tenant vacates

A retail business owner enters into a commercial 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.

tenant improvements
Improvements made to a rented property to meet the needs of the occupying tenant. [See **RPI** Form 552 §11]

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]

Landlord's right to improvements

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).

Leasehold improvement provisions

further-improvements provision
A commercial lease provision which allows a landlord to retain tenant improvements or require the restoration of the property to its original condition upon expiration of the lease. [See **RPI** Form 552 §11.3]

Commercial 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 **RPI** 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

- 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 **RPI** Form 552 §11]

Failure to make improvements

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 **RPI** 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]

Improvements promised by the tenant

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.

3 **Souza** v. **Joseph** (1913) 22 CA 179
4 CC §1657

Case in point

The controlling lease agreement

A landlord agrees to construct the shell of a building for a tenant. The tenant agrees to install all other improvements and fixtures required to occupy and use the property.

Before the building is completed by the landlord, the building code is changed to require the installation of a sprinkler system. The tenant demands the landlord pay the cost of installing the sprinkler system since the tenant cannot occupy the premises without the sprinkler system.

The landlord refuses to pay the additional cost to install the sprinkler system, claiming the lease agreement calls for them to build the structure, not to make it ready for occupancy.

Is the tenant responsible for the costs to install the sprinkler system?

*Yes! The tenant is responsible for making the alterations or improvements required to bring the building into compliance with use ordinances. The tenant had agreed in the lease agreement to make all improvements within the structure needed to take occupancy. [**Wong** v. **diGrazia** (1963) 60 C2d 525]*

mandatory improvement
An improvement required to be made under the terms of the lease or rental agreement.

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.[5]

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.[6]

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.

Tenant's failure to construct improvements

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 needs to complete the building. The landlord terminates the tenant's right to occupancy, evicts the tenant and completes the construction promised by the tenant.

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.[7] [See Case in point, "The controlling lease agreement"]

Landlord's consent to improvements

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.[8]

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 they 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.[9]

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7 **Sanders Construction Company, Inc.** v. **San Joaquin First Federal Savings and Loan Association** (1982) 136 CA3d 387

8 **Thriftimart, Inc.** v. **Me & Tex** (1981) 123 CA3d 751

9 **Whipple** v. **Haberle** (1963) 223 CA2d 477

Permissive improvements by the tenant

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**.

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

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]

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 mortgage. 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.

10 **Kusmark** v. **Montgomery Ward and Co.** (1967) 249 CA2d 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]

Surrender of improvements

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 commercial 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.

11 **City of Stockton** v. **Stockton Plaza Corporation** (1968) 261 CA2d 639
12 **Kanner** v. **Globe Bottling Co.** (1969) 273 CA2d 559

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*.

Real estate fixtures vs. 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]

real estate fixture
Personal property attached to the real estate as an improvement, which becomes part of the conveyable real estate.

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.

trade fixture
Fixtures used to render services or make products for the trade or business of a tenant.

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]

reversion
The conveyance of real estate fixtures from a tenant to landlord on expiration of a lease.

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 §§660; 1013

15 **City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562

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.[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.[17]

Reimbursement for tenant improvements on wrongful eviction

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.[18]

Trade fixtures as security

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 **Asell** 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 mortgage 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]

Notice of nonresponsibility

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]

mechanic's lien
A lien entitling a contractor or subcontractor to foreclose on a job site property to recover the amount due and unpaid for labor and materials they provided.

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]

notice of nonresponsibility
A notice used by a landlord to declare that they are not responsible for any claim arising out of the improvement being constructed on their property. [See **RPI** Form 597]

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]

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19 **Goldie** v. **Bauchet Properties** (1975) 15 C3d 307
20 CC §8442(a)
21 CC §8444
22 **Peterson** v. **Freiermuth** (1911) 17 CA 609

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF NONRESPONSIBILITY
From Landlord (California Civil Code §3094)

NOTE: This form is used by a property manager or income property owner when a tenant commences construction of improvements on premises leased from the owner, to declare the property owner is not responsible for any claim arising out of the tenant improvements being constructed on the property.

DATE: ____________, 20______, at ____, California.

NOTICE IS HEREBY GIVEN:

1. ____ is the vested and legal owner of real property located in the County of ____________________________, State of California, identified as
   1.1 Common address ____
   1.2 Legal description

2. ____ is:
   2.1 ☐ The Buyer of the property under a purchase agreement, option or land sales contract, or
   2.2 ☐ The Tenant under a lease of the property.

3. Within 10 days before the posting and recording of this notice, the undersigned Owner or Agent of Owner obtained knowledge that a work of improvement has commenced on the site of the property involving ☐ construction, ☐ alteration, or ☐ repair.

4. Owner will not be responsible for any claim arising out of this work of improvement.

5. I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: ______________, 20________ Name: ______________________________________

Signature: ______________________________________
☐ Owner, or ☐ Agent of Owner

A notary public or other officer completing this certificate verifies only the identity of the individual who signed the document to which this certificate is attached, and not the truthfulness, accuracy, or validity of that document.

STATE OF CALIFORNIA
COUNTY OF ______________________________
On ____________________ before me, ______________________________
(Name and title of officer)
personally appeared ____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

(This area for official notarial seal)

Signature: ______________________________
(Signature of notary public)

FORM 597 03-15 ©2016 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Form 597

Notice of Nonresponsibility

Nonresponsibility on mandatory improvements

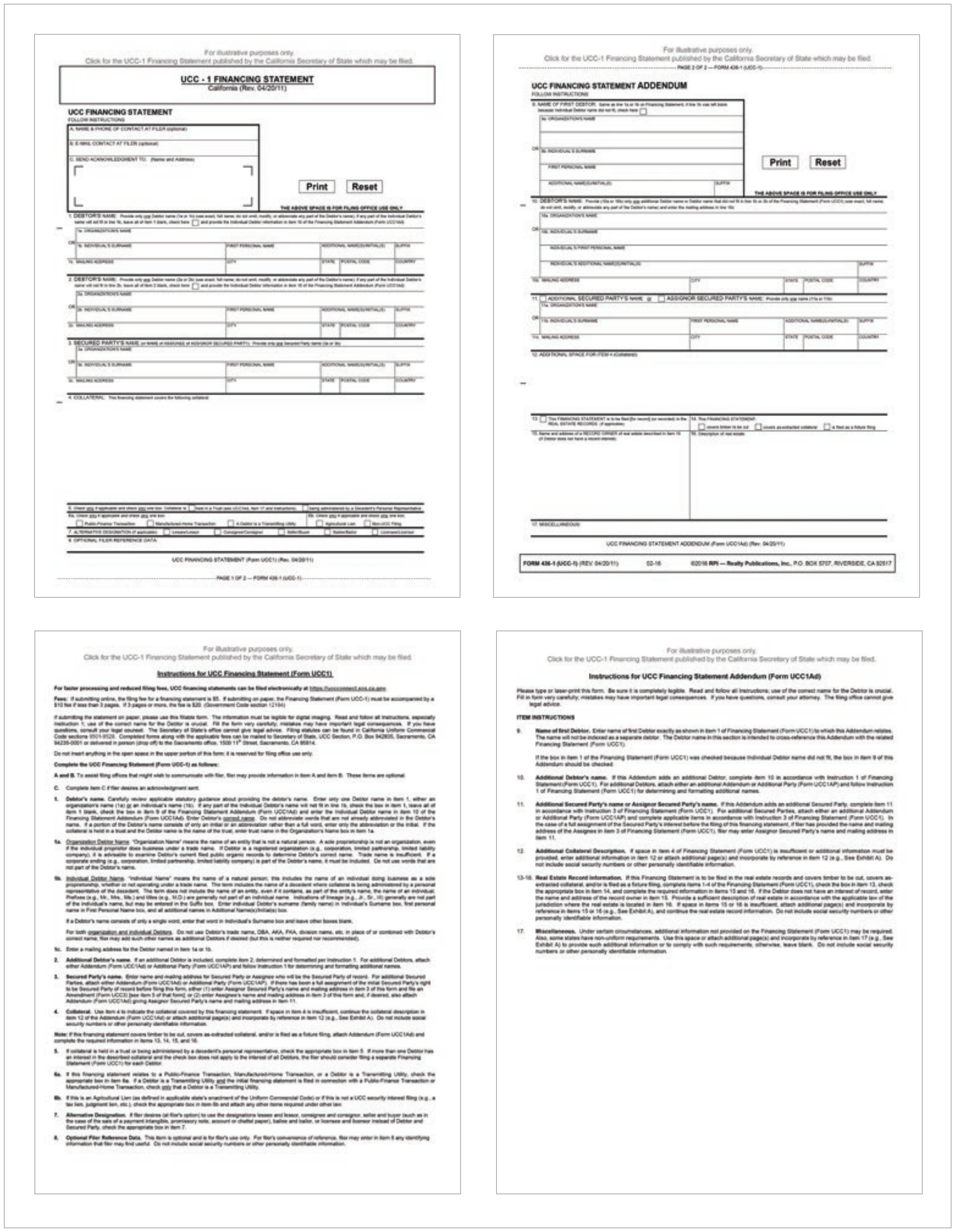
Further, if the lease requires the tenant to make *mandatory improvements,* a mechanic's lien attaches to the landlord's interest even when the landlord has posted and recorded a Notice of Nonresponsibility.

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.

Figure 1

Form 436-1

UCC-1 Financing Statement



For illustrative purposes only.

UCC - 1 FINANCING STATEMENT

UCC FINANCING STATEMENT ADDENDUM

Print Reset

Instructions for UCC Financing Statement (Form UCC1)

Instructions for UCC Financing Statement Addendum (Form UCC1Ad)

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

24 **Baker** v. **Hubbard** (1980) 101 CA3d 226

Additionally, a mechanic's lien cannot be recorded against the landlord if the improvements are removed by the contractor recording the lien.

Removal of fixtures by contractor

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]

Failure to perfect a lien

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

Chapter 11 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 11 Key Terms

Chapter 12

A property manager's responsibilities

Learning Objectives

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

An evolving standard of conduct

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 Department of Real Estate (DRE) broker license**. Any licensed agent or broker associate employed by the broker acts on behalf of their broker, not independent of their broker.[1]

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]

Requisite competence to manage

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:

trust account
A bank account used to hold trust funds.

- 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.

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

Management obligations owed the landlord

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.

prudent investor standard
A property management standard reflecting the expectations of a well-informed investor for efficient and effective management of rental income and expenses.

The prudent investor standard

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.

Property analysis to understand the tasks

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.

Liens affect commercial tenants

Along with the condition of the property, a property manager operating commercial 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 **RPI** 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 commercial tenant's move-in costs and tenant improvements are at risk of loss if the pre-existing lender forecloses.

Title profile analysis avoids surprises

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

property profile
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

- comparable sales information for the area.

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.

Due diligence and the paper trail

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. [See **RPI** Form 520]

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 work load to administrative employees or resident managers. This delegation is permitted since the property manager is charged with oversight as the responsible supervisor and employer.

Handling UD actions in small claims

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]

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]

A party other than the landlord files the UD

Consider a licensed real estate broker who operates a property management business as a sole proprietorship under their individual DRE 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 **RPI** 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

4 Calif. Code of Civil Procedure §116.540(h)
5 CCP §116.540(i)
6 CCP §116.540(j)

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]

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.

Property inspections by the manager

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 **RPI** 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.

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7 **Allen** v. **Dailey** (1928) 92 CA 308

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 **RPI** 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.

Periodic review of the leases

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 ageing. 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 **RPI** 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.

Earnings from all sources disclosed

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 benefiting 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 **RPI** 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]

Goodwill is value maintained or lost

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.

8 Jerry v. Bender (1956) 143 CA2d 198

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.

Reserves and deposits in the trust account

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.[9]

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.

start-up fee
A flat, one-time fee charged by a property manager for the time and effort taken to become sufficiently familiar with the operations of the property to commence management.

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 commercial properties, the security deposit accounting is mailed 30 days after a commercial tenant's departure.[10]

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:

trust funds
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

- security deposits;

9 10 Calif. Code of Regulations §2830
10 Calif. Civil Code §1950.5(g)(1); 1950.7(c)(1)

- rents;
- cash reserves; and
- start-up fees.[11]

Separate ledger for each landlord

Again, trust accounts are maintained in accordance with *standard accounting procedures*. These standards are best met by using computer software designed for property management.[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.[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.[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.[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.[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

11 Bus & P C §10145(a); California Department of Real Estate Regulations §2832
12 DRE Reg. §2831
13 DRE Reg. §2834(a)
14 DRE Reg. §2834(c)
15 DRE Reg. §2831(a)
16 DRE Reg. §2831(c)

- 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 DRE Reg. §2831.1
18 DRE Reg. §2831.1(b)
19 DRE Reg. §2832
20 Bus & P C §10148
21 DRE Reg. §2831.1
22 DRE 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 DRE-approved form.[23]

Handling of trust account funds

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.

commingling
The mixing of personal funds with client or other third-party funds required to be held in trust.

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

Failure to account for funds

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 DRE regarding the property manager's conduct while under contract.

The DRE 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 DRE properly revokes the property manager's real estate broker license.[24]

Management conflicts with sales operations

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

prospective tenant applying to rent a property they manage, the manager needs to diligently pursue rental or lease agreements with them. The conflict of interest arising when a client seeks the same or different purposes does not bar a broker from conflicting activities so long as the conflict has been timely and properly disclosed. [See **RPI** Form 527]

The landlord comes first. The broker's concern for greater fees always comes second.

Chapter 12 Summary

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.

Chapter 12 Key Terms


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Chapter 13

Property management agreement disclosure

Learning Objectives

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

Authority to operate a rental property

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]

property management agreement
An employment agreement setting the rights, responsibilities and expectations of both the property manager and the landlord. [See **RPI** 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, mortgage payments and management fees.[1]

Short-form vs. long-form agreements

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.

Property managed "as is"

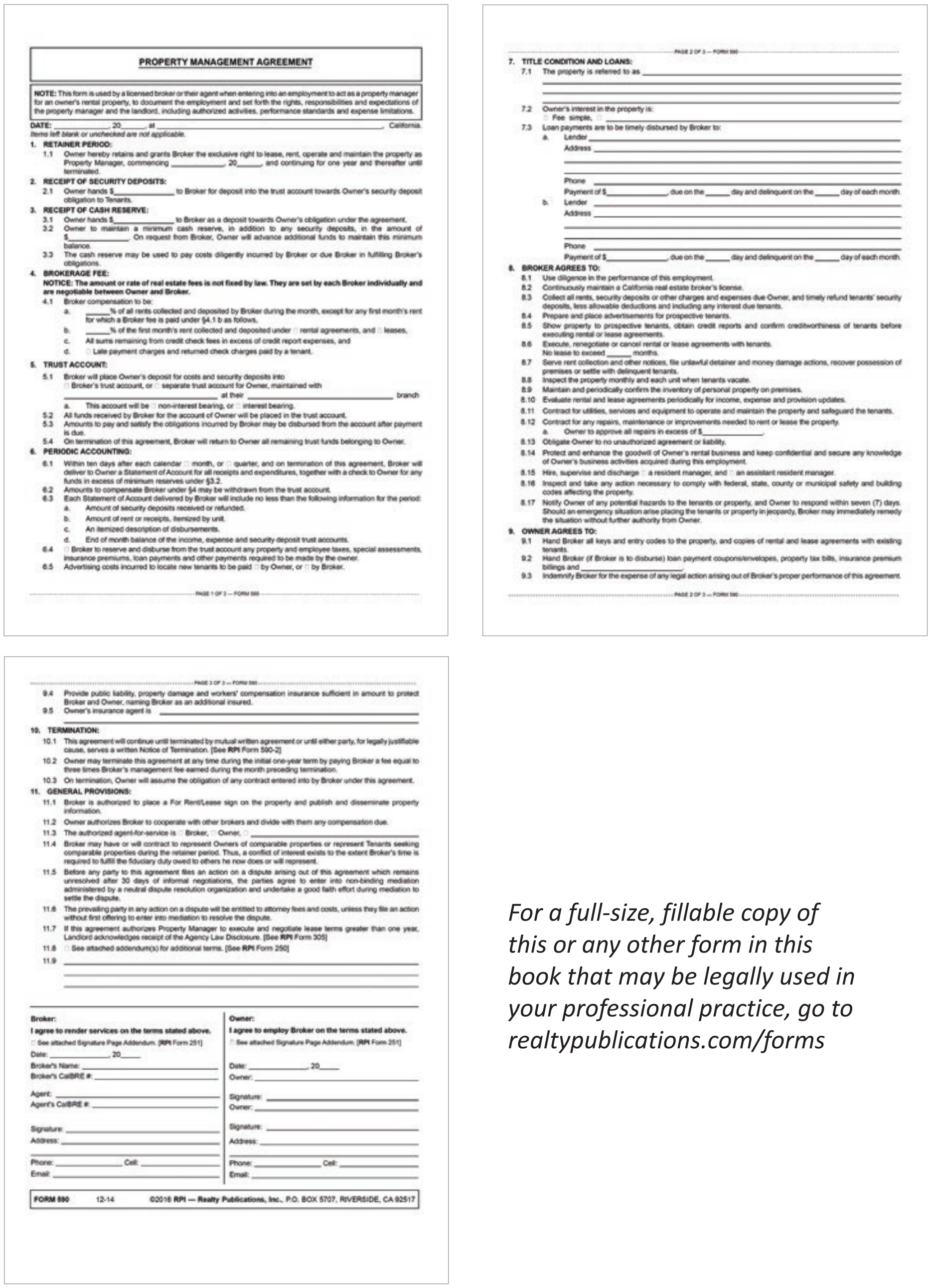
Some landlords want their property maintained at a below-standard level. A broker taking on the management of a property from such a landlord needs to document the maintenance they recommend. This can be accomplished by adding an addendum to the property management agreement or by

1 Calif. Civil Code §1624(a)(3)

Figure 1

Form 590

Property Management Agreement



PROPERTY MANAGEMENT AGREEMENT

NOTE: This form is used by a licensed broker or their agent when entering into an employment to act as a property manager for an owner's rental property, to document the employment and set forth the rights, responsibilities and expectations of the property manager and the landlord, including authorized activities, performance standards and expense limitations.

DATE: ____________, 20____, at ____________________________________, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Owner hereby retains and grants Broker the exclusive right to lease, rent, operate and maintain the property as Property Manager, commencing ____________, 20____, and continuing for one year and thereafter until terminated.

2. RECEIPT OF SECURITY DEPOSITS:

2.1 Owner hands $____________ to Broker for deposit into the trust account towards Owner's security deposit obligation to Tenants.

3. RECEIPT OF CASH RESERVE:

3.1 Owner hands $____________ to Broker as a deposit towards Owner's obligation under the agreement.

3.2 Owner to maintain a minimum cash reserve, in addition to any security deposits, in the amount of $____________. On request from Broker, Owner will advance additional funds to maintain this minimum balance.

3.3 The cash reserve may be used to pay costs diligently incurred by Broker or due Broker in fulfilling Broker's obligations.

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and are negotiable between Owner and Broker.

4.1 Broker compensation to be:

a. ______% of all rents collected and deposited by Broker during the month, except for any first month's rent for which a Broker fee is paid under §4.1 b as follows,

b. ______% of the first month's rent collected and deposited under ☐ rental agreements, and ☐ leases,

c. All sums remaining from credit check fees in excess of credit report expenses, and

d. ☐ Late payment charges and returned check charges paid by a tenant.

5. TRUST ACCOUNT:

5.1 Broker will place Owner's deposit for costs and security deposits into ☐ Broker's trust account, or ☐ separate trust account for Owner, maintained with ____________________ at their ____________________ branch

a. This account will be ☐ non-interest bearing, or ☐ interest bearing.

5.2 All funds received by Broker for the account of Owner will be placed in the trust account.

5.3 Amounts to pay and satisfy the obligations incurred by Broker may be disbursed from the account after payment is due.

5.4 On termination of this agreement, Broker will return to Owner all remaining trust funds belonging to Owner.

6. PERIODIC ACCOUNTING:

6.1 Within ten days after each calendar ☐ month, or ☐ quarter, and on termination of this agreement, Broker will deliver to Owner a Statement of Account for all receipts and expenditures, together with a check to Owner for any funds in excess of minimum reserves under §3.2.

6.2 Amounts to compensate Broker under §4 may be withdrawn from the trust account.

6.3 Each Statement of Account delivered by Broker will include no less than the following information for the period:

a. Amount of security deposits received or refunded.

b. Amount of rent or receipts, itemized by unit.

c. An itemized description of disbursements.

d. End of month balance of the income, expense and security deposit trust accounts.

6.4 ☐ Broker to reserve and disburse from the trust account any property and employee taxes, special assessments, insurance premiums, loan payments and other payments required to be made by the owner.

6.5 Advertising costs incurred to locate new tenants to be paid ☐ by Owner, or ☐ by Broker.

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7. TITLE CONDITION AND LOANS:

7.1 The property is referred to as ____________________________________

7.2 Owner's interest in the property is:
☐ Fee simple, ☐ ____________________

7.3 Loan payments are to be timely disbursed by Broker to:

a. Lender ____________________
Address ____________________
Phone ____________________
Payment of $____________, due on the ______ day and delinquent on the ______ day of each month.

b. Lender ____________________
Address ____________________
Phone ____________________
Payment of $____________, due on the ______ day and delinquent on the ______ day of each month.

8. BROKER AGREES TO:

8.1 Use diligence in the performance of this employment.

8.2 Continuously maintain a California real estate broker's license.

8.3 Collect all rents, security deposits or other charges and expenses due Owner, and timely refund tenants' security deposits, less allowable deductions and including any interest due tenants.

8.4 Prepare and place advertisements for prospective tenants.

8.5 Show property to prospective tenants, obtain credit reports and confirm creditworthiness of tenants before executing rental or lease agreements.

8.6 Execute, renegotiate or cancel rental or lease agreements with tenants.
No lease to exceed ______ months.

8.7 Serve rent collection and other notices, file unlawful detainer and money damage actions, recover possession of premises or settle with delinquent tenants.

8.8 Inspect the property monthly and each unit when tenants vacate.

8.9 Maintain and periodically confirm the inventory of personal property on premises.

8.10 Evaluate rental and lease agreements periodically for income, expense and provision updates.

8.11 Contract for utilities, services and equipment to operate and maintain the property and safeguard the tenants.

8.12 Contract for any repairs, maintenance or improvements needed to rent or lease the property.

a. Owner to approve all repairs in excess of $____________.

8.13 Obligate Owner to no unauthorized agreement or liability.

8.14 Protect and enhance the goodwill of Owner's rental business and keep confidential and secure any knowledge of Owner's business activities acquired during this employment.

8.15 Hire, supervise and discharge ☐ a resident manager, and ☐ an assistant resident manager.

8.16 Inspect and take any action necessary to comply with federal, state, county or municipal safety and building codes affecting the property.

8.17 Notify Owner of any potential hazards to the tenants or property, and Owner to respond within seven (7) days. Should an emergency situation arise placing the tenants or property in jeopardy, Broker may immediately remedy the situation without further authority from Owner.

9. OWNER AGREES TO:

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

9.2 Hand Broker (if Broker is to disburse) loan payment coupons/envelopes, property tax bills, insurance premium billings and ____________________.

9.3 Indemnify Broker for the expense of any legal action arising out of Broker's proper performance of this agreement.

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9.4 Provide public liability, property damage and workers' compensation insurance sufficient in amount to protect Broker and Owner, naming Broker as an additional insured.

9.5 Owner's insurance agent is ____________________

10. TERMINATION:

10.1 This agreement will continue until terminated by mutual written agreement or until either party, for legally justifiable cause, serves a written Notice of Termination. [See RPI Form 590-2]

10.2 Owner may terminate this agreement at any time during the initial one-year term by paying Broker a fee equal to three times Broker's management fee earned during the month preceding termination.

10.3 On termination, Owner will assume the obligation of any contract entered into by Broker under this agreement.

11. GENERAL PROVISIONS:

11.1 Broker is authorized to place a For Rent/Lease sign on the property and publish and disseminate property information.

11.2 Owner authorizes Broker to cooperate with other brokers and divide with them any compensation due.

11.3 The authorized agent-for-service is ☐ Broker, ☐ Owner, ☐ ____________________

11.4 Broker may have or will contract to represent Owners of comparable properties or represent Tenants seeking comparable properties during the retainer period. Thus, a conflict of interest exists to the extent Broker's time is required to fulfill the fiduciary duty owed to others he now does or will represent.

11.5 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.

11.6 The prevailing party in any action on a dispute will be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

11.7 If this agreement authorizes Property Manager to execute and negotiate lease terms greater than one year, Landlord acknowledges receipt of the Agency Law Disclosure. [See RPI Form 305]

11.8 ☐ See attached addendum(s) for additional terms. [See RPI Form 250]

11.9 ____________________

Broker:	**Owner:**
I agree to render services on the terms stated above.	**I agree to employ Broker on the terms stated above.**
☐ See attached Signature Page Addendum. [RPI Form 251]	☐ See attached Signature Page Addendum. [RPI Form 251]
Date: ____________, 20____	Date: ____________, 20____
Broker's Name: ____________	Owner: ____________
Broker's CalBRE #: ____________	Signature: ____________
Agent: ____________	Owner: ____________
Agent's CalBRE #: ____________	Signature: ____________
Signature: ____________	Address: ____________
Address: ____________	Phone: ____________ Cell: ____________
Phone: ____________ Cell: ____________	Email: ____________
Email: ____________	

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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 mortgage 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, mortgage 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

2 Calif. Business and Professions Code §10146

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 12]

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]

Broker fee enforcement for management services

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]

Structuring management fees

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. 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.

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3 **Apollo Estates Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625
4 **Phillippe** v. **Shapell Industries Inc.** (1987) 43 C3d 1247
5 Bus & P C §10148

Figure 2

Form 135 (Partial)

Request for Homeowner Association Documents

REQUEST FOR HOMEOWNER ASSOCIATION DOCUMENTS
(California Civil Code §1368.2)

NOTE: This form is used by a seller's agent when preparing a listing/marketing package or performing a due diligence investigation on a unit in a common interest development (CID), to obtain homeowners' association (HOA) documents for disclosing the condition of the property and CID to a buyer.

DATE: ______________, 20_____, at ____, California.

TO HOMEOWNERS' ASSOCIATION (HOA):
HOA's name ______________________________
Representative's name ______________________
Address ________________________________
____
Phone ____________ Cell ________________
Email __________________________________

FROM SELLER'S AGENT:
Agent's name ____________________________
Broker's name ____________________________
Address ________________________________
____
Phone ____________ Cell ________________
Email __________________________________

1. Property address: ____
   ____
   Seller of property: ____
   Seller's mailing address: ____
   ____
2. The HOA is kindly requested to provide the Seller's Agent with the HOA documents referenced on page two and three within 10 calandar days of this request.
3. The HOA is authoriazed by the Seller to supply Seller's Agent the requested copies of the HOA documents.
4. Once complete:
   ☐ mail a physical copy of the requested documents to Seller's Agent's address above;
   ☐ email a copy of the requested documents to Seller's Agent at ______________________________.
   CC Seller at ______________________________; or
   ☐ inform Seller's Agent where the requested documents are available in digital form online.
5. Please send the HOA's billing for the actual costs of copying and delivering the requested documents to Seller's Agent.

I agree to the terms stated above
Date: ______________, 20 _________
Seller's Name: ______________________________

Signature: ______________________________
Seller's Name: ______________________________

Signature: ______________________________

Date: ______________, 20 _________
Broker's Name: ______________________________
CalBRE#: ______________________________
Agent's Name: ______________________________
CalBRE#: ______________________________

Signature: ______________________________

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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]

Management of CIDs

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.

common interest developments
Condominiums projects, cooperatives or single family residences in a planned unit development. [See **RPI** Form 135]

managing agent
A broker who manages membership, common areas and accounting for a common interest development.

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 12]

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]

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

6 Bus & P C §10147.5
7 **People** v. **National Association of Realtors** (1984) 155 CA3d 578
8 CC §5375
9 Bus & P C §11504
10 CC §5380

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]

11 CC § 4525

Chapter 13 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 13 Key Terms

Chapter 14

Exclusive authorization to lease

Learning Objectives

After reading this chapter, you will be able to:

- understand the broker's right to compensation for services when employed by a commercial 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.

Key Terms

contingency fee clause

early termination clause

exclusive authorization to lease

exclusive right-to-collect clause

full listing offer to lease

leasing agent

open listing

safety clause

Leasing agent's bargain for fees

Consider commercial property that 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*.

leasing agent
A broker who markets the availability of space to rent and locates and negotiates the terms of a lease with suitable tenants.

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.

exclusive authorization to lease
A written agreement between a broker and client employing the broker to render services in exchange for a fee on the leasing the property to a tenant located by anyone. Also known as a listing. [See **RPI** Form 110]

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.

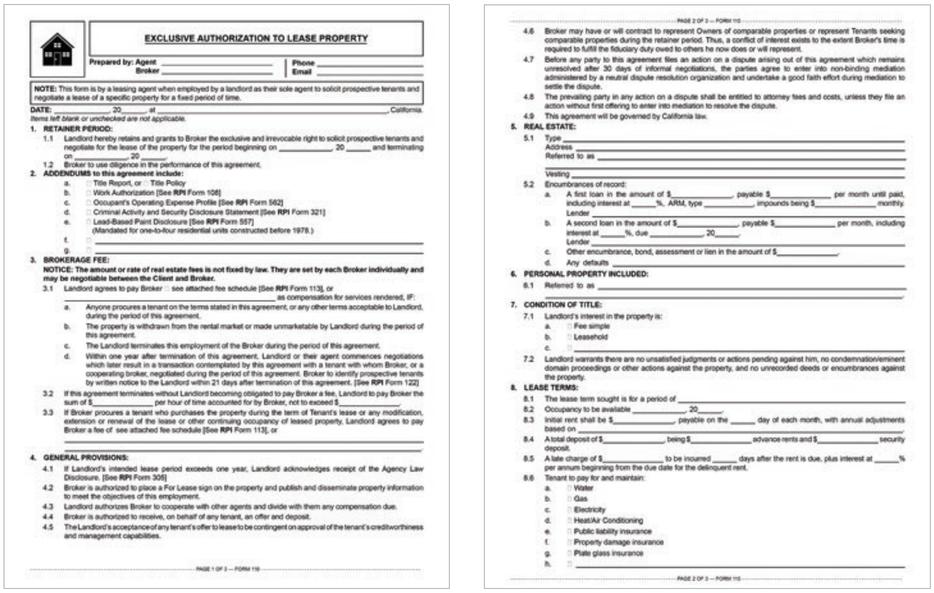
Is the broker correct?

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

Figure 1

Form 110

Exclusive Authorization to Lease Property



EXCLUSIVE AUTHORIZATION TO LEASE PROPERTY

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

NOTE: This form is by a leasing agent when employed by a landlord as their sole agent to solicit prospective tenants and negotiate a lease of a specific property for a fixed period of time.

DATE: ____________, 20____, at ______________________________, California.
Items left blank or unchecked are not applicable.

1. **RETAINER PERIOD:**
   1.1 Landlord hereby retains and grants to Broker the exclusive and irrevocable right to solicit prospective tenants and negotiate for the lease of the property for the period beginning on ____________, 20____ and terminating on ____________, 20____.
   1.2 Broker to use diligence in the performance of this agreement.
2. **ADDENDUMS to this agreement include:**
   a. ☐ Title Report, or ☐ Title Policy
   b. ☐ Work Authorization [See **RPI** Form 108]
   c. ☐ Occupant's Operating Expense Profile [See **RPI** Form 562]
   d. ☐ Criminal Activity and Security Disclosure Statement [See **RPI** Form 321]
   e. ☐ Lead-Based Paint Disclosure [See **RPI** Form 557] (Mandated for one-to-four residential units constructed before 1978.)
   f. ☐ ______________
   g. ☐ ______________
3. **BROKERAGE FEE:**
   NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between the Client and Broker.
   3.1 Landlord agrees to pay Broker ☐ see attached fee schedule [See **RPI** Form 113], or ______________ as compensation for services rendered, IF:
      a. Anyone procures a tenant on the terms stated in this agreement, or any other terms acceptable to Landlord, during the period of this agreement.
      b. The property is withdrawn from the rental market or made unmarketable by Landlord during the period of this agreement.
      c. The Landlord terminates this employment of the Broker during the period of this agreement.
      d. Within one year after termination of this agreement, Landlord or their agent commences negotiations which later result in a transaction contemplated by this agreement with a tenant with whom Broker, or a cooperating broker, negotiated during the period of this agreement. Broker to identify prospective tenants by written notice to the Landlord within 21 days after termination of this agreement. [See **RPI** Form 122]
   3.2 If this agreement terminates without Landlord becoming obligated to pay Broker a fee, Landlord to pay Broker the sum of $____________ per hour of time accounted for by Broker, not to exceed $____________.
   3.3 If Broker procures a tenant who purchases the property during the term of Tenant's lease or any modification, extension or renewal of the lease or other continuing occupancy of leased property, Landlord agrees to pay Broker a fee of see attached fee schedule [See **RPI** Form 113], or ______________.
4. **GENERAL PROVISIONS:**
   4.1 If Landlord's intended lease period exceeds one year, Landlord acknowledges receipt of the Agency Law Disclosure. [See **RPI** Form 305]
   4.2 Broker is authorized to place a For Lease sign on the property and publish and disseminate property information to meet the objectives of this employment.
   4.3 Landlord authorizes Broker to cooperate with other agents and divide with them any compensation due.
   4.4 Broker is authorized to receive, on behalf of any tenant, an offer and deposit.
   4.5 The Landlord's acceptance of any tenant's offer to lease to be contingent on approval of the tenant's creditworthiness and management capabilities.

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   4.6 Broker may have or will contract to represent Owners of comparable properties or represent Tenants seeking comparable properties during the retainer period. Thus, a conflict of interest exists to the extent Broker's time is required to fulfill the fiduciary duty owed to others he now does or will represent.
   4.7 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.
   4.8 The prevailing party in any action on a dispute shall be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.
   4.9 This agreement will be governed by California law.
5. **REAL ESTATE:**
   5.1 Type ______________
   Address ______________
   Referred to as ______________
   Vesting ______________
   5.2 Encumbrances of record:
      a. A first loan in the amount of $__________, payable $__________ per month until paid, including interest at ____%, ARM, type __________, impounds being $__________ monthly. Lender ______________
      b. A second loan in the amount of $__________, payable $__________ per month, including interest at ____%, due __________, 20____. Lender ______________
      c. Other encumbrance, bond, assessment or lien in the amount of $__________.
      d. Any defaults ______________
6. **PERSONAL PROPERTY INCLUDED:**
   6.1 Referred to as ______________
7. **CONDITION OF TITLE:**
   7.1 Landlord's interest in the property is:
      a. ☐ Fee simple
      b. ☐ Leasehold
      c. ☐ ______________
   7.2 Landlord warrants there are no unsatisfied judgments or actions pending against him, no condemnation/eminent domain proceedings or other actions against the property, and no unrecorded deeds or encumbrances against the property.
8. **LEASE TERMS:**
   8.1 The lease term sought is for a period of ______________
   8.2 Occupancy to be available __________, 20____.
   8.3 Initial rent shall be $__________, payable on the ____ day of each month, with annual adjustments based on ______________.
   8.4 A total deposit of $__________, being $__________ advance rents and $__________ security deposit.
   8.5 A late charge of $__________ to be incurred ____ days after the rent is due, plus interest at ____% per annum beginning from the due date for the delinquent rent.
   8.6 Tenant to pay for and maintain:
      a. ☐ Water
      b. ☐ Gas
      c. ☐ Electricity
      d. ☐ Heat/Air Conditioning
      e. ☐ Public liability insurance
      f. ☐ Property damage insurance
      g. ☐ Plate glass insurance
      h. ☐ ______________

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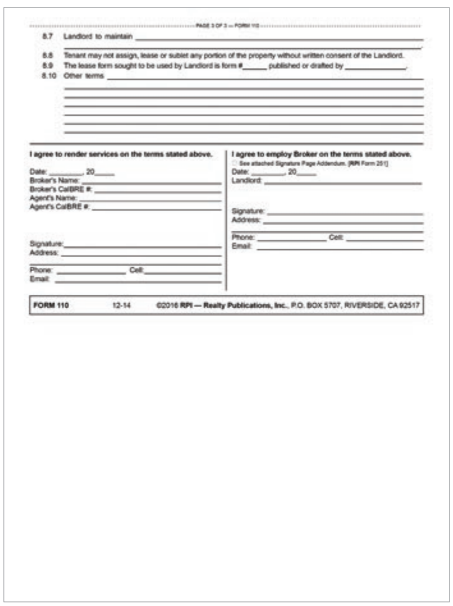

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   8.7 Landlord to maintain ______________
   8.8 Tenant may not assign, lease or sublet any portion of the property without written consent of the Landlord.
   8.9 The lease form sought to be used by Landlord is form #____ published or drafted by __________.
   8.10 Other terms ______________

I agree to render services on the terms stated above.	**I agree to employ Broker on the terms stated above.**
Date: ________, 20____	☐ See attached Signature Page Addendum. [RPI Form 251]
Broker's Name: ________	Date: ________, 20____
Broker's CalBRE #: ________	Landlord: ________
Agent's Name: ________	Signature: ________
Agent's CalBRE #: ________	Address: ________
Signature: ________	Phone: ________ Cell: ________
Address: ________	Email: ________
Phone: ________ Cell: ________	
Email: ________	

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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]

1 **Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247

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]

Exclusive authorization to locate a user

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.

open listing
An employment entered into by a broker to render real estate services on a best-efforts basis under which a fee is due to the broker if they achieve the client's objective of the employment before the client or another broker separately first meet the objective, such as the sale or locating of 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.

Fee schedule establishes broker's right to 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 **RPI** Form 113]

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];
- an *early termination clause* assures 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];

2 **Shell** v. **Darneille** (1984) 162 CA3d 957

- a **termination-of-agency clause** assures 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* assures 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]

termination-of-agency clause
A provision which assures payment of the broker's fee if the owner cancels the employment without cause before the listing expires. [See **RPI** Form 102 §3.1(c), 103 §4.1(b), 110 §3.1c]

Ready, willing and able tenant condition

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 **RPI** Form 556]

full listing offer to lease
A buyer's or tenant's offer to buy or lease on terms substantially identical to the employment terms in the owner's listing agreement with the broker. [See **RPI** 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]

An exclusive right-to-collect clause

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." [See Figure 1, Form 110 §3.1a]

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.

3 **Twogood** v. **Monnette** (1923) 191 C 103

exclusive right-to-collect clause
A provision which assures payment of the broker's fee if anyone procures a tenant on the terms in the listing, or on terms the landlordowner accepts. [See **RPI** Form 110 §3.1a]

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.[4]

Early termination by owner triggers fee

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. [See Figure 1, Form 110 §3.1b]

early termination clause
A provision which assures payment of the broker's fee if the owner withdraws the property from the market during the listing period. [See **RPI** Form 110 §3.1c]

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.

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.

4 **Carlsen** v. **Zane** (1968) 261 CA2d 399

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 **RPI** Form 121 for an agreement to cancel an exclusive authorization to lease during the listing period.*

Safety clause covers prospects who lease

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]

safety clause
A provision in an exclusive listing agreement earning the broker a fee during an agreed safety period after expiration of the employment for marketing efforts with identified buyers, tenants or property, if the client sells the listed property to an identified buyer or purchases or leases an identified property during the safety period. [See **RPI** Form 102 §3.1(d), 103 §4.1(c) and 110 §3.1(d)]

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 **RPI** 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.

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.

5 **Blank** v. **Borden** (1974) 11 C3d 963

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.

Contingency fees due on owner's breach

contingency fee clause
A provision in an offer-to-lease which states the broker's fee is payable on the transfer of possession to the tenant. [See **RPI** Form 556 §15]

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 **RPI** 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 **RPI** 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

6 **Leonard** v. **Fallas** (1959) 51 C2d 649

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]

Additional fees on extension of lease

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.

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.

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]

7 **Steve Schmidt & Co.** v. **Berry** (1986) 183 CA3d 1299
8 **Seck** v. **Foulks** (1972) 25 CA3d 556
9 **John B. Kilroy Company** v. **Douglas Furniture of California, Inc.** (1993) 21 CA4th 26

Chapter 14 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:

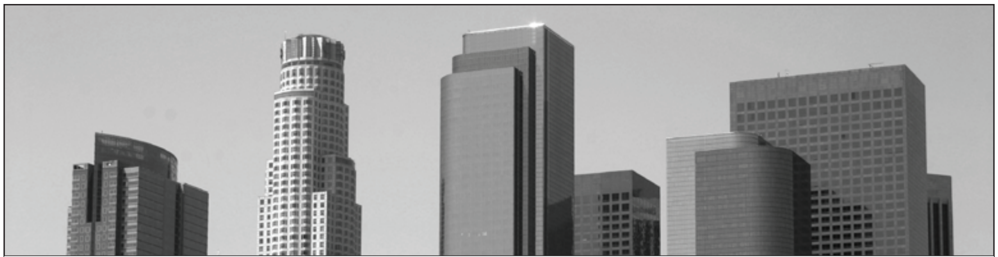
- the leasing terms sought in the listing; or
- any other terms accepted by the owner.

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 14 Key Terms



Chapter 15

Exclusive authorization to locate space

Learning Objectives

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.

Key Terms

agency duty

consultation fee

dual agency

exclusive authorization to locate space

general duty

A leasing agent and the commercial tenant

A landlord of a commercial 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.

Case in point

To know the tenant's expectations

Tenant needs and expectations

To effectively negotiate a commercial 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 **RPI** 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.*

Completed tenant registration form

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 **RPI** Form 556 §15]

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.

Case in point

To know the tenant's expectations

cont'd

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 **RPI** 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.

exclusive authorization to locate space
An employment agreement by a broker and a prospective tenant which authorizes the broker to act as the tenant's leasing agent to locate suitable space and negotiate a lease agreement. [See **RPI** Form 111]

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]

Various written fee agreements

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 commercial landlord for authorization to represent the landlord to locate users and negotiate acceptable leasing arrangements; [See Form 110]
- when the leasing agent solicits (or is solicited by) a commercial tenant for authorization to represent the tenant to locate suitable space and negotiate leasing arrangements acceptable to the tenant; [See Form 111]
- 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.

Employment agreements with a user

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.

1 **Rader Company** v. **Stone** (1986) 178 CA3d 10
2 **Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247

Form 111

Exclusive Authorization to Locate Space

EXCLUSIVE AUTHORIZATION TO LOCATE SPACE

Prepared by: Agent ______________________ **Phone** ______________________
Broker ______________________ **Email** ______________________

NOTE: This form is by a leasing agent when employed by a tenant as their sole agent to locate property and negotiate terms and conditions for its rental or lease for a fixed period of time.

DATE: ____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Tenant hereby retains and grants to Broker the exclusive right to locate space of the type described below and to negotiate terms and conditions for its rental acceptable to Tenant, for a retainer period beginning on ____________, 20______, and terminating on ____________, 20______.

2. BROKER'S OBLIGATIONS:

2.1 Broker to use diligence in the performance of this employment.

2.2 If Tenant's intended lease period exceeds one year, Tenant acknowledges receipt of the Agency Law Disclosure. [See **RPI** Form 305]

3. GENERAL PROVISIONS:

3.1 Tenant authorizes Broker to cooperate with other agents and divide with them any compensation due.

3.2 Broker may have or will contract to represent Owners of comparable properties or represent Tenants seeking comparable properties during the retainer period. Thus, a conflict of interest exists to the extent Broker's time is required to fulfill the fiduciary duty owed to others he now does or will represent.

3.3 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.

3.4 The prevailing party in any action on a dispute shall be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

3.5 This agreement will be governed by California law.

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between the Tenant and Broker.

4.1 Tenant agrees to pay Broker ☐ see attached fee schedule [See **RPI** Form 113], or ☐ ______________________ ______________________________________ of the rental price of the space located, IF:

a. Tenant, or any person acting on Tenant's behalf, leases space located during the retainer period;

b. Tenant terminates this employment of Broker during the retainer period; or

c. within one year after termination of this agreement, Tenant or their agent commences negotiations which later result in a transaction contemplated by this agreement with a landlord with whom Broker, directly or indirectly, negotiated during the period of this agreement. Broker to identify prospective properties by written notice to Tenant within 21 days after termination of this agreement. [See **RPI** Form 123]

4.2 If this agreement terminates without Tenant becoming obligated to pay Broker a fee, Tenant to pay Broker the sum of $______________ per hour of time accounted for by Broker, not to exceed $______________.

4.3 If Landlord of space leased to Tenant agrees to pay a fee acceptable to the Broker, Tenant's obligation to pay a brokerage fee will be satisfied.

TYPE OF SPACE SOUGHT:

GENERAL DESCRIPTION ____
LOCATION ______________________________ SIZE ______________________
RENTAL AMOUNT/TERM ____

I agree to render services on the terms stated above.
Date: ________, 20_____
Broker's Name: ______________________
Broker's CalBRE #: ______________________
Agent's Name: ______________________
Agent's CalBRE #: ______________________

Signature: ______________________
Address: ______________________
____
Phone: ______________ Cell: ______________
Email: ______________________

I agree to employ Broker on the terms stated above.
☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ________, 20_____
Tenant: ______________________

Signature: ______________________
Tenant: ______________________

Signature: ______________________
Address: ______________________
____
Phone: ______________ Cell: ______________
Email: ______________________

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The exclusive authorization to locate space form is similar in structure and purpose to an exclusive authorization to lease entered into by a landlord and includes:

- the term of the retainer period;
- the formula for calculating the broker's compensation and who will pay the fee [See Form 113];
- 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.

Exclusive authorization ensures collection of a fee

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]

consultation fee
A fee the broker charges for the time spent locating rental property if the tenant decides not to lease space during the exclusive authorization period. [See **RPI** Form 111 §4.2]

Benefits of exclusive authorization

An exclusive authorization to locate space is mutually beneficial to a prospective tenant and a broker. The employment commits the commercial 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.

agency duty
The fiduciary duty a broker owes a client to use diligence in attaining the client's real estate goals. [See **RPI** Form 305]

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.

general duty
The duty a licensee owes to non-client individuals to act honestly and in good faith with upfront disclosures of known conditions which adversely affect a property's value. [See **RPI** Form 305]

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.

Who controls the negotiations?

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.

Pay if you interfere with a broker's economic advantage

Consider a commercial 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.

dual agency
The agency relationship that results when a broker represents both the buyer and the seller in a real estate transaction. [See **RPI** Form 117]

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

3 **Buckaloo** v. **Johnson** (1975) 14 C3d 815

4 **Della Penna** v. **Toyota Motor Sales, U.S.A., Inc.** (1995) 11 C4th 376

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]

Need for a written employment agreement

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.

5 **L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300

Chapter 15 Summary

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.

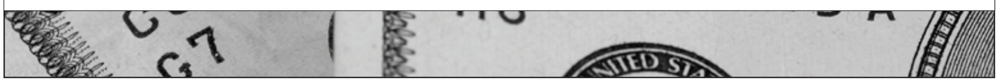
An exclusive authorization to locate space entered into by a prospective tenant assures the broker a fee if the tenant ultimately leases space of the type and in the area noted in the authorization. An exclusive authorization to locate space is mutually beneficial to a prospective tenant and a broker since it commits a commercial 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.

Chapter 15 Key Terms

Chapter 16

Cost of operating in leased space



Learning Objectives

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.

Key Terms

common area maintenance charge

comparative cost analysis

further-approval contingency

letter of intent

nonrecurring deposits or charges

operating costs

property expense profile

property operating data

recurring operating expenses

Disclosures by leasing agents

Property operating data is readily available as property management services are 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]

Tenant's cost of occupancy and ongoing operations

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**.

operating expenses
The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

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*.

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.

1 **Jue** v. **Smiser** (1994) 23 CA4th 312; Calif. Civil Code §2079
2 **Easton** v. **Strassburger** (1984) 152 CA3d 90
3 **Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18

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.

Tenant's expected costs as part of a marketing package

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.

Operating costs disclosed to tenants

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**; or
- rent and payments on mortgages secured by the tenant's leasehold.

recurring operating expenses
The regular and continuing costs of using and maintaining a property.

nonrecurring deposits or charges
One-time costs for which the tenant is responsible. [See **RPI** Form 550 §2]

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.

Form 562

Tenant's Property Expense Profile

TENANT'S PROPERTY EXPENSE PROFILE

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: This form is used by an owner and their leasing agent when preparing a marketing package for the lease of a residential property and disclosing the property's operating costs, to prepare a worksheet to be handed to prospective tenants for their review of the monthly property operating costs and deposits they will likely incur on taking possession of the property.

DATE: ____________, 20______, at ______________________________, California.
PROSPECTIVE TENANT ______________________________
1. PROPERTY TYPE ______________________________
1.1 Location ______________________________
1.2 Expense figures are estimates reflecting:
a. ☐ current expenses of occupancy.
b. ☐ forecast of anticipated expenses of occupancy.

2. MONTHLY OPERATING EXPENSES:
2.1 Electricity . . . . $__________
2.2 Gas . . . . $__________
2.3 Water . . . . $__________
2.4 TV (cable/satellite) . . . . $__________
2.5 Phone . . . . $__________
2.6 Internet . . . . $__________
2.7 Trash . . . . $__________
2.8 Sewage . . . . $__________
2.9 General obligation bonds . . . . $__________
2.10 Lawn/Gardening . . . . $__________
2.11 Maid/Housekeeping . . . . $__________
2.12 Pool/Spa . . . . $__________
2.13 Homeowners' Association (HOA) . . . . $__________
2.14 Maintenance and repair . . . . $__________
2.15 Property management services . . . . $__________
2.16 Insurance ____________________ . . . . $__________
2.17 Taxes ____________________ . . . . $__________
2.18 Other ____________________ . . . . $__________
2.19 **Total Operating Expenses** . . . . $__________
2.20 Monthly Lease Payment . . . . $__________
2.21 **Total Monthly Expenses** . . . . $__________

3. DEPOSITS:
3.1 Rental security deposit . . . . $__________
3.2 Electricity deposit . . . . $__________
3.3 Water deposit . . . . $__________
3.4 Sewage and rubbish deposit . . . . $__________
3.5 Gas service deposit . . . . $__________
3.6 Phone service deposit . . . . $__________
3.7 Other ______________ . . . . $__________
3.8 **Total Deposits** . . . . $__________

PAGE 1 OF 2 — FORM 562

comparative cost analysis
A comparison of the costs a tenant will incur to occupy and operate in a particular space against the costs to operate in other available space. [See **RPI** Form 562]

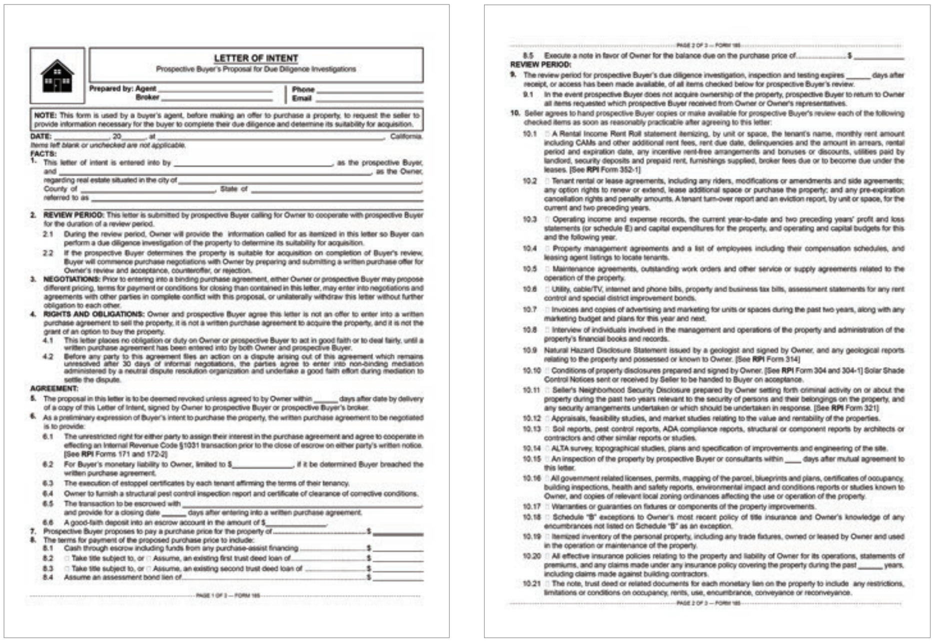
The tenant's *comparative cost analysis* is even more relevant to negotiations during periods of economic slowdown. Overbuilding or a decline in the number of commercial tenants increases vacancy levels. When this occurs, the economic function of the marketplace will dictate a reduced rent rate until 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.

Figure 1

Form 185

Letter of Intent



For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms

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.

The duty of a tenant's agent to investigate and advise

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.

property operating data
The actual costs of operating a property for its intended use.

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:

letter of intent (LOI)
A non-binding proposal signed and submitted to a property owner to start negotiations. [See **RPI** Form 185]

- 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.

CAMs incurred by the landlord, paid by the tenant

Leases on commercial 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 **RPI** 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.

common area maintenance charge
Property operating expenses incurred by a commercial landlord and paid by the tenant as rent in additon to the base rent, adjustments and percentages. [See **RPI** Form 552 §6]

Accurate estimates by leasing agents

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]

further-approval contingency
A provision in an offer to rent property which allows the tenant time to investigate and confirm the property information disclosed by the landlord.

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.

property expense profile
An itemized analysis of the costs a tenant or landlord will incur to operate and maintain a particular property. [See **RPI** Form 562]

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.

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4 **Ford** v. **Cournale** (1973) 36 CA3d 172

Chapter 16 Summary

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 16 Key Terms

Chapter 17

Tenant profiles

Learning Objectives

After reading this chapter, you will be able to:

- ascertain a tenant's needs when leasing property; and
- manage tenant requirements during leasing negotiations.

Key Terms

exclusive authorization to locate space

tenant lease worksheet

Get the negotiations rolling

A broker negotiating a commercial lease on behalf of a client needs to possess a high level of knowledge and expertise regarding different aspects of leasing, including:

- the economic attributes and financial results of lease agreements;
- the legal consequences of lease agreement provisions and title conditions affecting the tenant's right to possession; and
- the tax implications of the lease transaction.

A broker's technical expertise enables them to ascertain their client's needs and requirements, whether their client is a landlord or a tenant. Once the broker understands their client's objectives, the broker can locate either a suitable tenant (a **user**) or property (the **space** or **premises**). Then, what remains is to enter into lease negotiations.

Most commercial tenants are completely consumed by the constant demands of their business. They usually do not have sufficient time to devote to making decisions in real estate leasing transactions. Further, annual operating costs of leasing property represent a small fraction of the business's gross income, somewhere between 2% and 4%. High traffic shopping center space is the exception.

On the other hand, most landlords are primarily concerned with efforts to get vacant space rented. Consequently, landlords and tenants rely on brokers as their leasing agents to put the lease package together, which consists of property data disclosures and lease documents.

The final lease agreement negotiated by a leasing agent will be the result of:

- the relative bargaining strength of the landlord and tenant under current market conditions;
- the time the landlord and tenant are willing to devote and the urgency given to negotiating the leasing details;
- the expertise exercised and attention given to property and leasing details by their respective leasing agents; and
- local market conditions affecting user demand for the property and rent amounts.

The tenant's letter of intent

The broker usually gets the negotiations started with an **offer to rent** or **letter of intent (LOI)**. Once negotiations are underway, a broker's advice to their client helps shape the final terms. The tenant's broker drafts the initial offer or LOI. The lease agreement needs to be prepared by the tenant's agent if they are to maintain their advantage of making the first offer. Landlords with larger leasing operations often prepare their own documents "in house," or retain legal counsel to do so.

A leasing agent best determines the tenant's intentions for leasing property by preparing:

- a tenant lease worksheet to assess the tenant's space requirements and, with financial statements, the financial condition of the tenant's business [See Form 555 accompanying this chapter]; and
- an offer to lease and attached lease agreement to commit the tenant so an acceptance by the landlord will bring about an enforceable contract set by the terms of a lease agreement or a viable counteroffer. [See **RPI** Form 556]

A LOI will probably precede the tenant's actual offer in a casual effort to "feel out" the landlord. But this may backfire on the leasing agent if the landlord simply responds with a lease agreement as their proposal, stripping the tenant's leasing agent of control over lease agreement content.

List the tenant

With or without a written retainer agreement with a tenant, the leasing agent who undertakes the task of locating space for the tenant assumes agency obligations to act on behalf of, and in the best interest of, the tenant.

However, without a written agreement, the leasing agent has no assurance their fee, if earned, will be paid.[1]

1 **Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247

Thus, the prudent leasing agent only undertakes the duty to represent a tenant when the tenant signs an **exclusive authorization to locate space**. [See **RPI** Form 111]

Under a tenant's *exclusive authorization to locate space*, the broker is formally retained as the tenant's representative. Thus, the broker will be paid a leasing fee, either by the landlord or the tenant, if the tenant enters into a lease for the type of property described in the tenant's exclusive authorization agreement. [See **RPI** Form 111]

Tenant conferences

A leasing agent acting on behalf of a tenant needs to investigate and confirm why the tenant wants to move if the leasing agent is to better understand their user's needs.

For example, the tenant's existing space may have become too large or too small for their current or future needs. Alternatively, the tenant may be arguing with their current landlord over:

- the rent, common area maintenance charges (CAMs) or assessments when renewing a lease;
- the tenant's current space requirements that conflict with space provided for under an option to renew or extend; or
- a lease assignment or sublease of a portion of the leased space.

By uncovering the precise reasons for moving, the tenant's agent is better able to find a suitable new location and premises, or negotiate a renewal or extension of the tenant's current lease.

exclusive authorization to locate space
An employment agreement by a broker and a prospective tenant which authorizes the broker to act as the tenant's leasing agent to locate suitable space and negotiate a lease agreement. [See **RPI** Form 111]

The tenant's future needs

When a prospective tenant is starting a new business, the leasing agent needs to get information on the tenant's business projections at the outset. A tenant's new business projections may be overly optimistic. They 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. Rent might be paid by the landlord accepting a fractional participation in the ownership of the tenant's business.

Conversely, a tenant may underestimate the potential future growth of their business. The premises they favor may be too small to absorb their growth, frustrating later attempts to expand. The tenant will be forced to relocate again prematurely. In this case, the tenant may require options or the right of first refusal on additional space, or a lease cancellation or buyout provision so they may vacate the premises without liability for future rents under their lease agreement.

Also, over projection of the potential income of a tenant's business when entering into a percentage-rent lease will reduce the landlord's projected rental income. Unless the leasing agent considers the space needs and gross income of a user, the leasing agent's long-term service to either the landlord or tenant is limited. Thus, the leasing agent needs to develop a system to match the right landlord with the right tenant.

Form 555

Tenant Lease Worksheet

Page 1 of 3

TENANT LEASE WORKSHEET

Prepared by: Agent ____________________ **Phone** ____________________
Broker ____________________ **Email** ____________________

NOTE: This form is used by a leasing agent when representing a prospective commercial tenant in need of space, to determine the tenant's motivations, business needs and financial status, and the type of property and lease terms sought by the tenant.

DATE: ____________, 20______, at ______________________________, California.

1. **GENERAL INFORMATION:**
   Tenant's name ____________________
   Business address ____________________
   Phone ____________________ Fax ____________________
   Email ____________________
   Type of business ____________________
2. **Information on space presently occupied by Tenant:**
   - 2.1 Type of building: ☐ Multi-tenant ☐ Free-standing
   - 2.2 Location: ☐ Good ☐ Adequate ☐ Poor
   - 2.3 Suitability to business: ☐ Good ☐ Adequate ☐ Poor
   - 2.4 Square feet ____________ determined by ____________________
   - 2.5 Tenant utility costs:
     - a. ☐ Lighting/electrical. . . . . $__________
     - b. ☐ Gas. . . . . $__________
     - c. ☐ Water. . . . . $__________
     - d. ☐ ____________________ . . . . $__________
     - **TOTAL** . . . . $__________
   - 2.6 Tenant operating costs:
     - a. ☐ Common area maintenance (CAM). . . . . $__________
     - b. ☐ Casualty insurance. . . . . $__________
     - c. ☐ Use fees. . . . . $__________
     - d. ☐ Real property taxes. . . . . $__________
     - e. ☐ Maintenance. . . . . $__________
     - f. ☐ Assessments. . . . . $__________
     - g. ☐ Property management. . . . . $__________
     - h. ☐ Janitorial services. . . . . $__________
     - i. ☐ Parking. . . . . $__________
     - j. ☐ Fire insurance. . . . . $__________
     - k. ☐ ____________________ . . . . $__________
     - l. ☐ ____________________ . . . . $__________
     - **TOTAL** . . . . $__________
   - 2.7 Rooms/offices (number of):
     - ☐ Offices . . . . ______
     - ☐ Reception area. . . . . ______
     - ☐ Storage rooms . . . . ______
     - ☐ Kitchen. . . . . ______
     - ☐ Conference rooms . . . . ______
     - ☐ Lab/R&D rooms . . . . ______
     - ☐ Restrooms. . . . . ______
     - ☐ Dressing rooms . . . . ______
     - ☐ Computer room . . . . ______
     - ☐ Hallways . . . . ______
     - ☐ Lunchroom . . . . ______
     - ☐ ______________ . . . . ______
     - ☐ ______________ . . . . ______
     - ☐ ______________ . . . . ______
     - ☐ ______________ . . . . ______
   - 2.8 Tenant improvements and trade fixtures ____________________

PAGE 1 OF 3 — FORM 555

Using a tenant lease worksheet

Consider a tenant who runs an insurance agency that has more employees and files than the premises it now occupies will accommodate. The tenant has three agents and a support staff of eight people, including secretaries, an office manager and a full-time computer technician and webmaster.

The tenant expects the economy to allow the business to continue to grow. Thus, they need a larger space to meet their present and expanding needs.

Form 555

Tenant Lease Worksheet

Page 2 of 3

3. information on space sought by tenant:

3.1 Type of building: ☐ Multi-tenant ☐ Free-standing ☐ Rural

3.2 Location preferance: ☐ Downtown ☐ Suburbs
City ______________________ County ______________________

3.3 Access needed:

☐ Residential	☐ Legal/civic centers	☐ Shopping centers
☐ Agricultural	☐ Hotels	☐ Restaurants
☐ Industrial	☐ Libraries	☐ Redevelopment areas
☐ Mountain areas	☐ Universities/Colleges	☐ Government-state
☐ Freeways	☐ Financial services	☐ Government-federal
☐ Public transit	☐ Warehouses	☐ Publishing houses
☐ Parking	☐ Office centers	☐ Manufacturing centers
☐ Airports	☐ Convention centers	☐ Disposal facilities
☐ Coastal	☐ Sports facilities	☐ Trains
☐ Shipyards	☐ Near competition	☐ ______________
☐ Trucking	☐ Medical/hospital	

3.4 Space needs:

a. Square feet ____________

b. Rooms/offices:

☐ Offices	_____	☐ Storage rooms	_____
☐ Conference rooms	_____	☐ Restrooms	_____
☐ Computer rooms	_____	☐ Lunch rooms	_____
☐ Reception area	_____	☐ Kitchen	_____
☐ Lab/R&D rooms	_____	☐ Dressing rooms	_____
☐ Hallways	_____	☐ ____________	_____

3.5 Physical plant needs:

☐ Signs	_____	☐ Ceilings	_____
☐ Stairwells	_____	☐ Walls	_____
☐ Finishing	_____	☐ Floors	_____
☐ Partitions	_____	☐ Painting	_____
☐ Carpeting	_____	☐ Ramps/parking	_____

3.6 Utility needs:

☐ Lighting/electrical	_____	☐ Computer	_____
☐ Water	_____	☐ Gas	_____

4. Tenant business goals:

4.1 Short term (3-5 years)

____
____
____
____

4.2 Long term (5-10 years)

____
____
____
____

5. Lease terms on space now occupied by Tenant:

5.1 Type: ☐ Office ☐ Shopping center ☐ Retail
☐ Industrial ☐ Light business

5.2 Term ______________________ Expiration date ______ / ______ / ______

5.3 Base rent $____________ payable ______________________

5.4 Current rent $____________ payable ______________________

5.5 Rent based on: ☐ Per sq. ft. ☐ Percent gross sales

PAGE 2 OF 3 — FORM 555

The tenant contacts a leasing agent to locate space with tenant improvements suitable for their staff to occupy. The leasing agent explains they are the leasing agent for a number of landlords in the area and will be able to find suitable space for the tenant. The tenant is advised that, if needed, planners are available to design the use of the space and specify the tenant improvements for occupancy.

The leasing agent prepares a **tenant lease worksheet**. [See Form 555 accompanying this chapter]

tenant lease worksheet
A document the leasing agent uses to analyze the tenant's current financial condition and needs for leased space. [See **RPI** Form 555]

Form 555

Tenant Lease Worksheet

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5.6 Rental adjustments based on: ☐ CPI ☐ Reappraisal ☐ Graduated ☐ Fixed ☐ ____________

5.7 Security deposit . . . . $____________

5.8 Prepaid rent . . . . $____________

5.9 Option to renew/extend: ☐ Yes ☐ No

5.10 Opiton to buy: ☐ Yes ☐ No

5.11 Option to lease additional space: ☐ Yes ☐ No

5.12 Lease assignment: ☐ Freely ☐ Landlord consent

5.13 Other ____________

5.14 Landlord's name ____________

Business address ____________

Phone ____________ Fax ____________

Agent's name ____________

Phone ____________ Fax ____________

6. Lease terms sought:

6.1 Desired monthly base rent $____________

6.2 Rent based on: ☐ Per sq. ft. ☐ Percent gross sales

6.3 Rental adjustments based on: ☐ CPI ☐ Reappraisal ☐ Graduated ☐ Fixed ☐ ____________

6.4 Landlord responsibility for utilities:

☐ Lighting/electrical ☐ Gas

☐ Water ☐ ____________

6.5 Landlord responsibility for operating costs:

☐ Maintenance ☐ Insurance

☐ Property mgmt. ☐ Parking

☐ Use fees ☐ Janitorial

☐ Taxes ☐ ____________

6.6 Common area maintenance (CAM) provision cap:

☐ ____________ Per sq. ft. ☐ ______% Per year

6.7 Security deposit . . . . $____________

6.8 Prepaid rents . . . . $____________

6.9 Option to renew: ☐ Yes ☐ No [See **RPI** Form 565]

6.10 Option to buy: ☐ Yes ☐ No [See **RPI** Form 161]

6.11 Option to lease additional space: ☐ Yes ☐ No [See **RPI** Form 579-1]

6.12 Lease assignment: ☐ Freely ☐ Landlord consent [See **RPI** Form 595]

6.13 Other ____________

The *worksheet* covers three key areas the leasing agent needs to consider and analyze:

- the tenant's current lease agreement obligations and conditions of their existing space;
- the tenant's current and likely future needs for leased space; and
- the tenant's financial condition and creditworthiness.

Regarding the tenant's existing space, the leasing agent will determine:

- the type of building;
- the square footage;
- the monthly operating and utility costs; and
- the tenant improvements and trade fixtures.

Agent's review of the tenant's current lease

A necessary review of the tenant's current lease includes:

- the expiration date;
- monthly rent and periodic adjustments and assessments;
- the obligation to continue to occupy the premises;
- the obligation to restore the premises or remove tenant improvements;
- options to extend or renew the lease or buy the premises;
- the tenant's ability to assign or sublease; and
- the amount of the security deposit.

These facts will help the leasing agent determine the tenant's rights and obligations under their present lease for timing the tenant's relocation. When representing the tenant, the leasing agent needs to point out and explain, to the best of their ability, their knowledge of the beneficial or detrimental effect any lease provisions have on the tenant.

When representing an owner, the leasing agent will advise them which terms the tenant is unhappy with and which lease provisions are "throw away" clauses. Such clauses are designed for negotiations and are of little or no concern to the owner.

Locating new space

Next, the leasing agent ascertains the tenant's needs and goals for the new space.

Regarding the space requirements, the leasing agent will need to uncover the tenant's:

- current square footage needs;
- future square footage needs;
- phone, utilities and computer facility 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, shopping and restaurants; and
- any needs peculiar to the tenant.

Some tenants may focus on specific geographic locations in the business market or population centers. Others may need the lowest rent possible, regardless of location within the geographic area they wish to conduct business.

On completing a tenant lease worksheet, the leasing agent discovers the tenant wants to:

- stay in the same community because of their many strong business and social ties to the area;
- keep their rent fixed or have predictable (fixed) annual adjustments over the next three to five years; and
- move closer to the freeway for quick access to customers in outlying areas.

Tenant needs

The tenant currently needs 4,000 square feet to accommodate:

- four private offices;
- a computer room;
- a reception area;
- a conference room;
- a storage room;
- restrooms;
- a lunch room; and
- areas for sales staff and secretaries.

Financially, the business is profitable, but the tenant wants to keep rent at no more than 4% of gross income. Additionally, the tenant is concerned future inflation will mount. Thus, they do not want their rent adjustments tied to the Consumer Price Index (CPI). If they have to be, then a ceiling needs to be set on any annual rise in the CPI beyond 3%.

Also, the leasing agent might suggest negotiating for an option to lease additional space if adjacent space becomes available and necessary for expansion (and an additional fee for the leasing agent if exercised).

Finally, the leasing agent and the tenant need to discuss the rental terms available in the leasing market. Several provisions in leases have a financial impact, favorable or not, on the landlord and the tenant. Financial aspects of a lease agreement include:

- base monthly rent;
- periodic rental adjustments (CPI or percentage);
- payment of real estate taxes and insurance premiums;
- tenant improvements;
- responsibility for general maintenance (CAMs);
- structural, roofing and HVAC maintenance;
- government ordered retrofitting;
- lease assignability and subletting authority;
- options to renew or extend, or to buy; and
- personal guarantees or letters of credit.

Chapter 17 Summary

The prudent leasing agent only undertakes the duty to represent a tenant when the tenant signs an exclusive authorization to locate space.

The leasing agent's goal to locate space for the tenant involves several steps. First the leasing agent prepares a tenant lease worksheet. The worksheet covers three key areas the leasing agent needs to consider and analyze:

- the tenant's current lease conditions and existing space;
- the tenant's current and future needs for leased space; and
- the tenant's financial condition and creditworthiness.

These facts will help the leasing agent determine the tenant's rights and obligations under their present lease agreement.

Next, the leasing agent ascertains the tenant's needs and objectives to be met in the new space. Finally, the leasing agent and the tenant need to discuss the rental terms available in the leasing market.

Chapter 17 Key Terms


CAN'T DECIDE WHAT TO WATCH?
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Chapter 18

Commercial tenant screening

Learning Objectives

After reading this chapter, you will be able to:

- identify aspects of a commercial tenant's background needing further investigation prior to entering into a lease agreement; and
- proceed with a credit screening investigation.

Key Terms

balance sheet **profit and loss statement**

Qualified to stay and pay

An owner's leasing agent, when reviewing an application to rent from a prospective commercial tenant, has a duty to the owner to review the tenant's qualifications. A commercial lender reviews a person's qualifications to borrow money in the same way.

Like lending money, leasing real estate is an extension of credit. Rent paid for the use of property is comparable to interest paid for the use of money. Both financial arrangements have the same economic function since each generates a rate of return — one called **rent**, the other called **interest**.

Further, the owner conveys to the tenant the right to use the property, comparable to a lender advancing money for use by a borrower. Both are on loan. Finally, property let to a tenant is to be returned to the owner, just as money lent to a borrower is returned to the lender without a decrease in value.

Thus, the leasing agent and landlord analyze the prospective tenant's creditworthiness and whether they're qualified to take possession of the property, pay for its use in a timely manner and return it undiminished as agreed.

Credit report partial information

A credit report provides only partial information on a commercial tenant's creditworthiness. Credit reports do not evaluate the tenant's managerial ability to successfully operate their trade or business and care for the premises. Also, they do not consider the tenant's assets (net worth) or the profitability of the business. However, investigative reports carry this type of information.

profit and loss statement
A type of financial statement which discloses the tenant's business income, expenses and net operating income. [See **RPI** Form 209-2]

balance sheet
An itemized, dollar-value presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values. [See **RPI** Form 209-3]

A tenant, on inquiry from a leasing agent, will provide financial statements on their company. The tenant's business income, expenses and net operating income (NOI) are disclosed in the tenant's **profit and loss statement**, a type of financial statement. The tenant's **balance sheet** is a separate financial statement which sets forth the tenant's net worth (assets) and liabilities (debts). [See Form 209-2 accompanying this chapter; see **RPI** Form 209-3]

Occasionally, start-up companies do not have computer-generated financial statements. In this event, financial statement forms are available from institutional lenders and forms publishers for tenants.

The information contained in financial statements supplied voluntarily by the tenant needs to be confirmed by the owner or their leasing agent. Most credit agencies will perform this activity for a fee. The credit application usually supplies the name and address of banks and creditors of the tenant.

Leasing agents may also check out the property currently occupied by commercial tenants to see if the tenant failed to maintain the property. A diminished property value on the tenant's return of possession is what an owner wants to avoid. Investigating the tenant's behavior before entering into a leasing agreement will help establish with more certainty what risk the tenant's conduct poses for the owner.

For managers of commercial property, the added dimension of the tenant's business operations and conduct needs to be considered. The tenant's business acumen and style of marketing from the premises will have an effect on occupants of adjacent space.

Also, leasing agents need to give the same review to a substitute tenant seeking to assume an existing lease and to a prospective tenant negotiating a new lease. When a lease agreement contains an alienation provision stating the owner's consent "will not be unreasonably withheld," the owner needs to hold the substitute tenant to the same standards used to qualify new tenants.

Using different qualifying standards is an unreasonable interference with the commercial tenant's right to sell their business and transfer the leasehold to the substitute tenant for the remainder of the term.

Purpose of background checks

A commercial manager, leasing agent or owner conducts a background check on a new tenant to determine their:

- credit history;
- financial status;
- business track record and proposed business plans;

- compatibility with other tenants and class of clientele;
- ability to manage their business; and
- ability to maintain the property's value.

Credit and financial history

Before a prospective tenant's credit and financial history can be analyzed by the owner, the prospective tenant needs to complete a **credit application**, also called an application to rent. On receiving the tenant's credit application, the owner and their leasing agent may begin the process of verifying the tenant's payment history based on the information supplied by the tenant and reports ordered from credit agencies. [See **RPI** Form 302]

Any possible adverse information, such as foreclosures, bankruptcies, tax liens, evictions, violations of use ordinances or records of arrests, needs to be given weight when analyzing the tenant's acceptability.

Editor's note — Litigious and troublesome tenants are to be shunned since they come with baggage and attitudes adverse to problem-free landlord-tenant relationships.

Business track record

Extensive financial data on the prospective tenant's business is readily available to the owner upon request. Financial information on the tenant's business operations is usually provided through financial statements, including:

- *profit and loss*, income and operating statements for the current and preceding year; and
- a *balance sheet* for the last day of the month preceding the application to rent.

Attention needs to be focused on the tenant's:

- prior work experience;
- business or professional licenses;
- familiarity with their proposed use of the property;
- degree of responsibility;
- managerial skills;
- vocational or educational experience;
- business acumen and survivability;
- name recognition and length of time in the community; and
- civic and community involvement.

The prospective commercial tenant's income statement and balance sheet statement need to be examined for:

- income, expenses and net operating income (NOI) ratios;
- ability to maintain or increase sales;
- budget and income projections;

Form 209-2

Profit and Loss Statement

PROFIT AND LOSS STATEMENT

Borrower's Financial Statement (FNMA 1020)

Prepared by: Agent ______________________ **Phone** ______________________

Broker ______________________ **Email** ______________________

NOTE: This form is used by a loan broker when processing a mortgage application to be prepared by the borrower for the loan broker, to determine the borrower's sources and amounts of income, personal expenses and net income and set the borrower's debt-to-income (DTI) ratios.

	Servicer Loan Number:
Property Address:	
Is your home listed for sale? ☐ Yes ☐ No	
Agent's Name:	Agent's Phone Number:
Borrower's Name:	Social Security Number:
Mailing Address (P.O Box, Street, Apt):	
Mailing Address (City, State, Zip):	
Total number of persons living at this address:	Number of dependents at this address:
Home phone:	Work phone
Co-Borrower Name:	Social Security Number:
Mailing Address (#, Street, Apt):	
Mailing Address (City, State, Zip):	
Total number of persons living at this address:	Number of dependents at this address:
Home phone:	Work phone

Have you contacted credit counseling services? ☐ Yes ☐ No

Number of cars you own:

Monthly Income (wages): $ / mo.

Additional Income (not wages): $ / mo. * Source:

* Notice: Alimony, child support or separate maintenance income need not be revealed if the Borrower or Co-Borrower does not choose to have it considered for approval of:

Asset Type:	Estimated value	**Liability Type:**	Monthly payment	Balance Due
Other Real Estate:	$	Dependent Care:	$	$
Checking Accounts:	$	Rent:	$	$
Savings/Money Market:	$	Other Mortgage(s):	$	$
IRA/Keogh Accounts:	$	Personal Loans(s):	$	$
401(k)/ESOP Accounts:	$	Medical Expense:	$	$
Stocks, Bonds, CDs:	$	HOA Fees/Dues:	$	$
Other Investments:	$	Other:	$	$

Reason for delinquency:

I (we) agree that the financial information provided is an accurate statement of my (our) financial status. I (we) understand and acknowledge that any action taken by the lender of my (our) mortgage loan on my (our) behalf will be made in strict reliance on the financial information provided: My (Our) signature(s) below grants the holder of my (our) mortgage the authority to confirm the information I (we) have disclosed in this financial statement, to verify that it is accurate by ordering a credit report, and to contact my real estate agent and/or credit counseling service representative (if applicable).

Submitted this ______________ Day of ______________ 20______

By: ______________________ ______________
Signature of Borrower *Date*

By: ______________________ ______________
Signature of Borrower *Date*

* Note: Before mailing, make sure you have signed and dated the form and attached a copy of your most recent pay stub. if you are self-employed, attach a copy of your most recent Federal Tax return.

FORM 209-2 03-11

- net cash flow;
- age of accounts payable;
- amortization periods and due dates of debts;
- cash reserves;
- ownership and control; and
- product performance and service satisfaction.

Also, most commercial tenants are structured as business entities, not operated as individual proprietorships. With an entity as the tenant, the landlord or leasing agent needs to pull records from the Secretary of State for California to determine if the company is in good standing with the state. It is also needed to determine who is registered with the state as the CEO/President/managing member permitted to enter into contracts, such as a lease agreement, binding the entity to the agreement.

Future plans and business goals

The tenant's future plans for the space and their business objective for the relocation are legitimate concerns of an owner. Some entrepreneurial owners accept stock or other share ownership in the tenant's company in lieu of rent for the leased space, particularly with business start-ups.

Regardless of the form in which rent will be paid, the owner needs to consider questions about the nature and substance of the tenant's operations, including:

- Is the tenant consolidating or expanding their operations?
- Do their income and expense projections, including the rent amounts, make sense?
- Does the business require the infusion of capital to relocate to new space?
- Does the tenant need to increase or reduce their debt or annual debt service?
- For tenants who are a corporation or limited liability company (LLC), is a stockholder or a member willing to personally guarantee the lease agreement or provide security?
- Will the activities of the tenant pose any zoning, ordinance or insurance coverage problems?
- Will the tenant's operations and the type of clientele it attracts enhance or impair the future value of the real estate?

Chapter 18 Summary

The leasing agent and landlord analyze the creditworthiness of prospective tenants. They investigate the tenant to determine whether the prospective tenant is qualified to take possession of the property, pay for its use in a timely manner and return it undiminished as agreed.

A commercial manager, leasing agent or owner conducts a background check on a new tenant to determine their:

- credit history;
- financial status;
- business track record and proposed business plans;
- compatibility with other tenants and class of clientele;
- ability to manage their business; and
- ability to maintain the property's value.

Extensive financial data on the prospective tenant's business is readily available to the owner upon request. Financial information on the tenant's business operations is usually provided through financial statements.

Chapter 18 Key Terms

Chapter 19

Security deposits and pre-expiration inspections

Learning Objectives

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 commercial 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.

Key Terms

final inspection

itemized statement of deduction

joint pre-expiration inspection

rent

security deposit

statement of deficiencies

Cover for a tenant's nonperformance

Both commercial 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 **RPI** 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;

security deposit
A source of funds to pay tenant obligations owed the landlord on the tenant's default in the rental or lease agreement.[See **RPI** Form 550 §2.1 and 552 §1.2]

- 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 strictly controlled.

Rent is paid in advance

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]

rent
Compensation received by a landlord in exchange for the tenant's use, possession and enjoyment of the property.

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 security deposits: not rents, not fees

Residential tenants, unlike commercial 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 landlords are prohibited from demanding or receiving a security deposit greater than the amount of **one month's rent** — regardless of whether the unit is furnished or unfurnished.[4]

However, the landlord may collect a security deposit equal to two months' rent when the landlord:

- is a **natural person** or a limited liability company (LLC) consisting solely of natural persons; and
- owns no more than two residential rental properties consisting of no more than four rental units total.[5]

The exception: when the tenant is a **service member**, landlords (including **mom-and-pop landlords**) may not charge the tenant for a security deposit amounting to more than one month's rent for an unfurnished unit, or two months' rent for a furnished unit.[6]

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)
5 CC §1950.5(c)(4)
6 CC §1950.5(c)(2)

Further, the landlord may not refuse to rent a unit to a service member due to this restriction on security deposits.[7]

Together with these security deposits, landlords are limited to collecting prepaid rent of no more than the first month's rent, unless a lease agreement for a term of six months or more exists, which allows the landlord to collect no less than six months' prepaid rent.[8]

Prior to 2024, residential security deposits were universally limited to:

- two months' rent for unfurnished units; and
- three months' rent for furnished units.[9]

Further, the one month's *advance rent* collected by the landlord is not included in the security deposit limit.

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. [10]

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.[11]

Uniform application of security deposits

Any funds received and 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. [12]

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.[13]

---

7 CC §1950.5(c)(2)
8 CC §1950.5(c)(2)
9 CC §1950.5(c)
10 CC §§1940.5; 1950.5(b), (c); 1950.6
11 CC §1950.5(c)
12 24 Code of Federal Regulations §100.60(b)(4)
13 Calif. Government Code §12955(a); 24 CFR §100.65

Case in point

To defer the first month's rent

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 commercial 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*

The additional waterbed-deposit

An additional security deposit may be demanded and collected when a tenant maintains a waterbed in an unfurnished rental unit. [See **RPI** 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.[14]

Commercial security deposits

A commercial landlord has the discretion to set security deposit amounts under a rental or lease agreement. Amounts set for commercial 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 commercial lease agreement, the amount of the security deposit is negotiable between the commercial landlord and the tenant prior to entering into the lease.

The problematic last month's rent

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.[15]

Commercial 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.

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14 CC §1940.5(g)
15 CC §1950.5(c)

Form 567-1

Notice of Right to Request a Joint Pre-Expiration Inspection

Page 1 of 2

NOTICE OF RIGHT TO REQUEST
A JOINT PRE-EXPIRATION INSPECTION

NOTE: This form is used by a property manager or landlord when a residential tenant will be vacating their unit, to notify the tenant of their right to request a joint pre-expiration inspection of the premises they occupy and receive a statement of deficiencies itemizing the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit.

DATE: ______________, 20______, at ____, California.
To Tenant: ____
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement
   1.1 dated ______________, at ______________________________, California,
   1.2 entered into by ______________________________, as the Tenant,
   1.3 and ______________________________, as the Landlord,
   1.4 regarding real estate referred to as ______________________________.
   1.5 which tenancy expires ______________, 20______.

NOTICE:

2. You are hereby advised of your right to request and be present at a pre-expiration inspection of the premises you occupy, and at the time of the inspection, be given Landlord's itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deduction from your security deposit. [See **RPI** Form 567-3]
   2.1 The purpose for the inspection and the statement of deficiencies is to give you the opportunity to remedy or eliminate the itemized deficiencies before vacating to avoid a deduction of their cost from your security deposit.
   2.2 The inspection, if requested by you, may be scheduled no earlier than two weeks before the expiration of your tenancy, and is separate from Landlord's final inspection and accounting for your security deposit within 21 days after you vacate.
   2.3 If you do not request a pre-expiration inspection, no inspection will be made prior to the final inspection after you vacate.
3. You may request an inspection at any time after you are given this notice by preparing the form attached to this notice and giving it to Landlord or their agent.
   3.1 On Landlord's receipt of your request, Landlord will attempt to set a mutually agreeable date and time for the inspection.
   3.2 On Landlord's receipt of your request, you will be given a written 48-hour notice of entry advising you of the date and time scheduled by Landlord for the inspection.
4. On completion of the scheduled inspection, whether or not you are present, Landlord or their agent will hand you or leave on the premises a copy of an itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deductions from your security deposit, unless you remedy or eliminate them prior to your vacating on or before your tenancy expires.
   4.1 Once you have requested an inspection you may withdraw the request at any time prior to the inspection.
5. **Notice:** State law permits former Tenants to reclaim abandoned personal property left at the former address of the Tenant, subject to certain conditions. You may or may not be able to reclaim property without incurring additional costs, depending on the cost of storing the property and the length of time before it is reclaimed. In general, these costs will be lower the sooner you contact your former Landlord after being notified that property belonging to you was left behind after you moved out.

Date: ______________, 20______
Landlord/Agent: ______________________ CalBRE #: ______________

Signature: ______________________________
Address: ______________________________

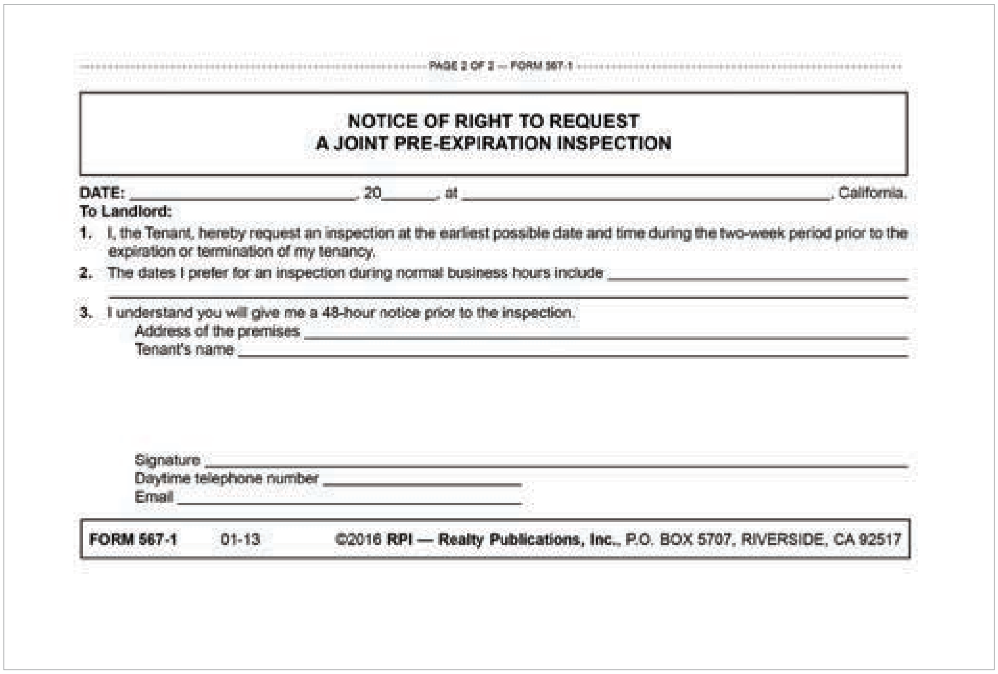
Phone: ______________________ Cell: ______________
Fax: ______________________________
Email: ______________________________

PAGE 1 OF 2 — FORM 567-1

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.



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NOTICE OF RIGHT TO REQUEST
A JOINT PRE-EXPIRATION INSPECTION

DATE: ______________, 20____, at ______________, California.
To Landlord:

1. I, the Tenant, hereby request an inspection at the earliest possible date and time during the two-week period prior to the expiration or termination of my tenancy.
2. The dates I prefer for an inspection during normal business hours include ______________
3. I understand you will give me a 48-hour notice prior to the inspection.

Address of the premises ______________
Tenant's name ______________

Signature ______________
Daytime telephone number ______________
Email ______________

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Form 567-1

Notice of Right to Request a Joint Pre-Expiration Inspection

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Landlord treatment of security deposits

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.[16]

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.[17]

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.

Joint pre-expiration inspections and the deposit

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 Form 567-1 §5 accompanying this chapter]

16 CC §§1950.5(d); 1950.7(b)

17 **Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054

Form 567-3

Statement of Deficiencies on Joint Pre-Expiration Inspection

Page 1 of 2

joint pre-expiration inspection
An inspection conducted by a residential landlord or the property manager to advise a tenant of the repairs the tenant needs to perform to avoid deductions from their security deposit. [See **RPI** Form 567-1]

STATEMENT OF DEFICIENCIES
ON JOINT PRE-EXPIRATION INSPECTION

NOTE: This form is used by a property manager or landlord when conducting a joint pre-expiration inspection of a leased premises, to provide the tenant an itemization of the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit.

DATE: ____________, 20____, at ______________________________, California.
To Tenant: ______________________________
Items left blank or unchecked are not applicable.

FACTS:

1. On this date, a pre-expiration inspection was conducted by Landlord on the premises and appurtenances which are the subject of a rental or lease agreement
   - 1.1 dated ______________, at ______________________________, California,
   - 1.2 entered into by ______________________________, as the Tenant(s), and ______________________________, as the Landlord,
   - 1.3 regarding real estate referred to as ______________________________.
   - 1.4 ☐ Tenant was present and given a copy of this statement prepared and signed by Landlord or their agent.
   - 1.5 ☐ Tenant was not present and a copy of this statement prepared and signed by Landlord or their agent was left inside the premises.
2. The tenancy under the rental or lease agreement expires on ____________, 20____, by which date you are to vacate the premises.
3. **NOTICE TO TENANT:**
   - 3.1 You have until the date for expiration of your tenancy to remedy or eliminate the repairs and cleaning specified in this Statement of Deficiencies to avoid the deduction from your security deposit of the cost to repair and clean the identified deficiencies.
   - 3.2 Unobservable conditions or conditions which occur after the pre-expiration inspection requiring repair and cleaning will be deducted from your security deposit after the final inspection by Landlord or their agent.

STATEMENT OF DEFICIENCIES:

4. The following itemized list of identified deficiencies in repairs and cleaning will be the basis for deductions from your security deposit, unless remedied or eliminated by you prior to vacating and later confirmed by Landlord or their agent during a final inspection after you vacate.
   - 4.1 Damage to the premises and appurtenances caused by Tenant or their guests, other than ordinary wear and tear, which needs to be repaired are listed as follows: ______________________________
   - 4.2 Cleaning which needs to be performed to bring the premises up to the level of cleanliness which existed on commencement of the tenancy is listed as follows: ______________________________

PAGE 1 OF 2 — FORM 567-3

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.

Form 567-3

Statement of Deficiencies on Joint Pre-Expiration Inspection

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5. The following recitals are excerpts from Civil Code §1950.5 regarding security deposits:

5.1 1950.5(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, any payment, fee, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a landlord for a tenant's default in the payment of rent.

(2) The repair of damages of the premises, exclusive of ordinary wear and tear, caused by the tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy necessary to return the unit to the same level of cleanliness it was in at the inception of the tenancy. The amendments to this paragraph enacted by the act adding this sentence shall apply only to tenancies for which the tenant's right to occupy begins after January 1, 2003.

(4) To remedy future defaults by the tenant in any obligation under the rental agreement to restore, replace, or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

5.2 1950.5(d) Any security shall be held by the landlord for the tenant who is party to the lease or agreement. The claim of a tenant to the security shall be prior to the claim of any creditor of the landlord.

Date: ______________, 20____
Landlord/Agent: ______________ CalBRE#: ____________

Signature: ______________________________
Address: ______________________________
____
Phone: ______________ Cell: ______________
Email: ______________________________

FORM 567-3 03-11

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.[18] [See Form 567-1]

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.

Notice of entry and statement of deficiencies

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:

18 CC §1950.5(f)(1)

Form 585

Security Deposit Disposition on Vacating Residential Premises

SECURITY DEPOSIT DISPOSITION
ON VACATING RESIDENTIAL PREMISES

NOTE: This form is used by a residential property manager or landlord when a tenant has vacated a premises and the landlord holds the tenant's security deposit, to provide the tenant with an itemized statement within 21 days of vacating of the security deposit's disposition and documentation of charges deducted.

DATE: ______________, 20____, at ______________________________, California.
TO TENANT:
Items left blank or unchecked are not applicable.

FACTS:

1. This is notice to Tenant of any Landlord deductions from the security deposit under the following agreement:
   - ☐ Residential lease agreement ☐ Occupancy agreement
   - ☐ Reseidential rental agreement ☐ ______________________
   - 1.1 dated ______________, 20____, at ______________________, California,
   - 1.2 entered into by ______________________________, as the Landlord,
   - 1.3 and ______________________________, as the Tenant,
   - 1.4 regarding residential premises referred to as ______________________.

DISPOSITION OF DEPOSIT:

2. Under the above referenced agreement, Tenant handed Landlord a security deposit in the amount of . . . . $__________
3. The following deductions have been made by Landlord from the security deposit:
   - 3.1 Repair of damages — Cost
     - a. ______________________ $______
     - b. ______________________ $______
   - 3.2 Necessary cleaning of the premises — Cost
     - a. ______________________ $______
     - b. ______________________ $______
   - 3.3 Delinquent or holdover rent — Amount
     - a. From ____________ To ____________ $______
   - 3.4 Replacement/repair of lost or damaged furnishings — Cost
     - a. ______________________ $______
   - 3.5 **TOTAL** deductions from security deposit (line 2 less line 3.4) . . . . (-)$__________
4. **BALANCE DUE TENANT:**
   - 4.1 Balance of security deposit remaining after deductions (line 2 less line 3.4) . . . . $__________
   - 4.2 Interest on the security deposit from ____________ to ____________ at ______ % per annum . . . . (+)$__________
   - 4.3 Balance due Tenant is refunded in the amount of (line 4.1 plus line 4.2) . . . . $__________ by Landlord / Agent's check #__________.
5. **AMOUNT DUE LANDLORD:**
   - 5.1 The amount due Landlord after deductions (line 2 less line 3.5) . . . . $__________
   - 5.2 Less interest on the security deposit from ____________ to ____________ at ______ % per annum . . . . (-)$__________
   - 5.3 Tenant to hand or mail Landlord/Agent the balance due of (line 5.1 less line 5.2) . . . . $__________

This statement is true and correct.
Date: ____________, 20______
Landlord/Agent: ______________ CalBRE #: ______________

Signature: ______________________
Address: ______________________

Phone: ______________ Cell: ______________
Email: ______________________

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- 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.[19] [See **RPI** Form 567-2]

19 CC §1950.5(f)(1)

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.

statement of deficiencies
A document a residential landlord presents to a vacating tenant specifying any repairs or cleaning to be completed by the tenant to avoid deductions from the security deposit. [See **RPI** Form 567-3]

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.[20]

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 **RPI** 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.*[21]

Residential deposit refund requirements

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.[22] [See Form 585 accompanying this chapter]

final inspection
An inspection of the premises conducted by the landlord within 21 days after a residential tenant vacates the property. [See **RPI** Form 585]

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.[23]

20 CC §1950.5(f)(2)
21 CC §1950.5(f)
22 CC §1950.5(g)
23 CC §1950.5(g)(2)

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.

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.[24]

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.[25]

No receipt or invoice copies

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.[26]

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.[27]

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.[28]

Reasonable deductions from the deposit

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.[29]

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24 CC §1950.5(g)(3)
25 CC §1950(g)(3)
26 CC §1950.5(g)(4)
27 CC §1950.5(g)(5)
28 CC §1950.5
29 CC §§1950.5(b); 1950.7(c)

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 **RPI** Form 560] [30]

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]

itemized statement of deductions
A document accounting for the tenant's security deposit, delivered by the landlord to a residential tenant after the tenant vacates. [See **RPI** 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.[31]

As an aside, on the landlord's sale of a residential or commercial 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.[32] [See **RPI** Form 586]

Commercial deposit refund rules

A commercial 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 **RPI** Form 552 through 552-4]

However, a commercial 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 commercial 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 commercial landlord is to return any remaining amount in excess of one month's rent

30 CC §1950.5(e)
31 CC §1950.5(l)
32 CC §§1950.5(h); 1950.7(d)

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.[33]

Unless otherwise stated in the rental or lease agreement, the commercial 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.[34]

Unlike the residential landlord, the commercial landlord is not required to provide tenants with an itemized statement of deductions when the security deposit is refunded. However, a prudent commercial 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 commercial landlord who, in bad faith, fails to comply with the refund requirements is liable to the tenant for up to $200 in penalties.[35]

33 CC §1950.7(c)
34 CC §1950.8(b)
35 CC §1950.7(f)

Chapter 19 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 commercial 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.

Chapter 19 Key Terms

final inspection .... **pg. 195**
itemized statement of deductions .... **pg. 197**
joint pre-expiration inspection .... **pg. 192**
rent .... **pg. 186**
security deposit .... **pg. 185**
statement of deficiencies .... **pg. 195**

Chapter 20

Security to prevent crimes

Learning Objectives

After reading this chapter, you will be able to:

- identify the landlord's responsibilities to reduce the risk of reasonably foreseeable crime; and
- understand the landlord's responsibilities to reduce the risk of crime or warn tenants upon obtaining knowledge of criminal activity on the leased premises.

Key Term

reasonably foreseeable

Protective measures and warnings

The landlord of an apartment complex is aware of recent assaults on tenants in the common areas of the property. The landlord has also received a composite drawing of the criminal and a description of the criminal's mode of operation released by the local police.

The landlord does not undertake any of the **security steps** available to reduce the risk of a recurrence of the same or similar criminal activities.

The landlord later rents a unit to a new tenant. The landlord does not disclose the recent criminal assaults or the criminal's mode of operation. The tenant is not given a copy of the composite drawing of the perpetrator developed by the police. Further, the landlord represents the complex as safe and patrolled by security.

Later, the tenant is assaulted by the same perpetrator inside the tenant's apartment unit, not in the areas open to the public. The tenant seeks to recover their money losses caused by the assault from the landlord. The tenant claims the landlord failed to disclose the prior assaults and misrepresented the safety of the apartment complex to induce the tenant to rent and occupy the unit.

The landlord claims they are not liable for the tenant's injuries since the assault occurred within the tenant's apartment unit and not in the common areas where the prior attacks occurred.

Here, the landlord is liable for injuries suffered by the tenant inside the apartment unit. The landlord knew of criminal activity on the premises and owed a duty to care for and protect the tenant by either:

- providing security measures in the common areas; or
- warning the tenant of the prior assaults.[1]

reasonably foreseeable
The possibility a crime or danger may occur due to a previous crime on the premises. A landlord has a duty to take reasonable measures to prevent harm to persons on the property or warning tenants of the prior criminal activity.

Based on the prior criminal incidents, the likelihood of similar future assaults on tenants is **reasonably foreseeable**. When criminal activity is *reasonably foreseeable* due to known prior criminal activity, the landlord has a duty to take reasonable measures to prevent harm to persons on the property from future similar criminal activities.

The landlord's failure to warn the new tenant about known criminal activity creates a risk that a tenant may be injured. Due to the landlord's further failure to put security measures in place to prevent harm, the landlord is liable for compensating the injured person by the payment of money, called **damages**.

Alternatively, the landlord may also be liable for the tenant's losses based on their intentional misrepresentation to the tenant regarding the safety of the apartment complex.

Editor's note — Like a landlord, a homeowners' association (HOA) has exclusive control over the maintenance of the common areas. Thus, like a landlord, an HOA has the duty to maintain the common areas.

An HOA is liable for money losses due to any injury caused by a dangerous condition which it knows about or should have known about.[2]

Degree of foreseeability of harm

Consider the landlord of a shopping center who has exclusive control over the maintenance and repair of the common areas. Burglaries and purse snatchings have recently occurred on the premises. However, the landlord is unaware of this criminal activity in the shopping center.

At tenant association meetings, concerns about the lack of security in the center are addressed. The tenant association decides not to hire security guards on account of the expense. The tenants do not discuss or bring their security concerns to the attention of the landlord.

Later, a tenant's employee is physically assaulted and injured on the leased premises.

The employee claims the landlord is liable for their injuries since the landlord failed to provide security guards to protect employees of tenants from an unreasonable risk of harm.

1 **O'Hara** v. **Western Seven Trees Corporation Intercoast Management** (1977) 75 CA3d 798
2 **Frances T.** v. **Village Green Owners Association** (1986) 42 C3d 490

The landlord claims they are not liable since the assault on the tenant's employee was a type of crime that was unforeseeable by the landlord.

Here, the landlord has no duty to provide security guards in the common areas. The prior crimes (theft) were not of a similar nature that would have made a physical assault foreseeable.[3]

The landlord's duty to provide protection is determined in part by balancing the **foreseeability of harm** against the burden imposed on the landlord to remove or prevent the harm. A high degree of foreseeability is necessary to impose a duty on a landlord or HOA to hire security guards.

Unless *prior incidents* of similar crimes are brought to the landlord's attention, the high degree of foreseeability required to impose a duty on the landlord to take steps to prevent or eliminate future injury does not exist.

However, prior similar incidents are not the only factor used in determining whether a landlord has a duty to take measures to prevent future criminal activity. The foreseeability of an injury is also determined by the circumstances surrounding the injury and its occurrence, such as the nature, condition and location of the premises.[4]

Reasonably foreseeable criminal activity

Consider a landlord of an office building and parking structure located in a high-crime neighborhood. Many petty thefts and acts of vandalism have occurred on the premises, but no assaults have taken place. The security system maintained by the landlord to monitor the parking structure is in disrepair and does not function.

A visitor returning to their car enters the parking structure while an armed robbery is taking place. The visitor is shot and killed.

The visitor's spouse seeks to recover money losses from the landlord, claiming the death of the spouse was reasonably foreseeable and could have been prevented by the landlord. The spouse also claims the landlord, who was aware of criminal activity on the premises, breached their duty to take measures to prevent further criminal activity.

The landlord claims the injury was not reasonably foreseeable since the prior criminal acts were not similar to the act causing the visitor's death.

Is the landlord liable for failing to provide adequate security in the parking structure?

Yes! The landlord's failure to properly maintain existing security features in light of prior criminal activity and the nature of a public parking structure is a breach of the duty of care the landlord owes to persons who enter the structure. Although the foreseeability of the type of criminal activity causing the death is low, the landlord is liable since the burden of maintaining the existing security system is minimal.

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3 **Ann M.** v. **Pacific Plaza Shopping Center** (1993) 6 C4th 666

4 Ann M., *supra*

Not only was the landlord aware of vandalism and thefts regularly occurring in the parking structure, the landlord knew the parking structure was located in a high-crime area. Further, parking structures by their dark and private nature tend to invite criminal activity. Death resulting from a visitor's accidental disruption of an armed robbery is reasonably foreseeable, even though no other armed assaults had previously occurred on the premises.[5]

No liability if not foreseeable

The extent of the security measures a landlord is required to provide is dictated by the degree of foreseeability of any future harm to others.[6]

When an injury is not foreseeable due to the nature, condition and location of the leased premises which do not indicate a person entering or using the property is at risk, a landlord is not liable if an injury which security measures may have prevented occurs on the premises.

Consider an apartment complex where previous criminal activity has not occurred. However, the community where the complex is located is generally known as a high-crime area.

The light bulb installed at the entrance to a tenant's apartment burns out. The tenant asks the landlord to replace the light bulb. The lighting in the common area is functional.

Before the landlord replaces the bulb, the tenant is assaulted in their unit, suffering injuries. The tenant claims the landlord is liable for their injuries since the landlord has a duty to provide adequate lighting as a security measure.

The landlord claims they are not liable since the light bulb outside the tenant's unit is for the tenant's convenience, and is not intended as a security measure to protect tenants.

Here, the landlord is not liable. Prior criminal activity had not occurred on the premises that would put the landlord on notice of foreseeable risks. The landlord has no duty to take security precautions against criminal activity. Further, lighting alone is not considered an adequate security measure for deterring crime.[7]

On-site, not off-site prevention

Tenants occupying an apartment complex have been victimized by numerous assaults and robberies in the garage area and courtyard. The landlord is aware of the criminal activity on the premises.

In response to tenants' complaints, the landlord promises to install additional lighting.

A tenant parks on the street instead of in the garage due to the inadequate lighting in the common areas. One night, while parking on the street, the

5 **Gomez** v. **Ticor** (1983) 145 CA3d 622

6 Ann M., *supra*

7 **7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901

tenant is attacked and injured. The tenant claims the landlord is liable for their injuries since the landlord's failure to provide adequate on-site lighting created a dangerous condition, forcing them to park on the street.

Is the landlord liable for the tenant's injuries that occurred on a public street?

No! The landlord does not have a duty to protect a tenant from criminal acts committed by others that injure the tenant when they are not on the leased premises.[8]

While the landlord's conduct may have caused the tenant to park in the street, the tenant's decision to park on the public street imposes no duty on the landlord to also eliminate dangerous off-premises conditions. A landlord's duty of care is to prevent harm to others in the maintenance and management of the leased premises, not adjoining properties.[9]

Prevent dangers within your control

The landlord's duty of care is derived from their ability to prevent the existence of dangerous conditions from existing on the property they control, not adjacent properties or public right of ways over which they have not taken control. A landlord is liable only when a connection exists between the harm suffered by the tenant and the landlord's care and maintenance of their property and any adjacent property over which the landlord takes control.

While the landlord in the prior scenario failed to exercise care in the maintenance and repair of their premises, the landlord exercised no control over the public street, nor did they create or permit the dangerous condition in the street which caused the tenant's injury.

The purpose for providing adequate lighting in the common areas of leased premises is to help protect tenants or others against the risk of criminal attacks on the leased premises, not on a public street where the responsibility for lighting and security lies with government agencies. The lack of adequate lighting in the apartment complex was not the cause of the attack suffered by the tenant on the public street; it only caused the tenant to use the street.[10]

Ability to control is not control

Now consider a landlord who is aware of criminal activity occurring on public property adjacent to the leased premises. A visitor leaves the leased premises at night via a public sidewalk adjacent to the premises. Lighting is not installed on the public side of the premises to illuminate the sidewalk.

While walking on the public sidewalk, the visitor is assaulted and injured. The visitor makes a demand on the landlord to recover money losses incurred due to their injuries. The visitor claims the landlord has a duty to protect patrons of tenants from criminal assaults on public sidewalks that provide access to the premises.

8 **Rosenbaum** v. **Security Bank Corporation** (1996) 43 CA4th 1084
9 Calif. Civil Code §1714
10 Rosenbaum, *supra*

The visitor contends the landlord knew criminal activity had occurred on the sidewalk and had the power to exert control over the sidewalk by installing lights on the outside of the building. The sidewalk was the means of ingress and egress to the building.

Is the landlord liable for the client's injuries due to a dangerous condition on adjacent property?

No! The landlord does not owe a duty of care to anyone to take control over an adjoining property and remove or prevent injury from dangerous conditions existing on the adjoining property. The landlord is not liable for failing to take steps to prevent possible injuries from occurring on a public sidewalk adjacent to the leased premises that are regularly used by tenants for access to their units.[11]

The landlord's failure to provide lighting for a public sidewalk that the landlord does not own or control did not create the dangerous condition that caused the assault against the tenant's client. The fact the landlord can influence or alter the condition of the public sidewalk by voluntarily adding lighting in no way indicates they have control over the sidewalk, which would impose liability for failure to provide off-site security.[12]

11 **Donnell** v. **California Western School of Law** (1988) 200 CA3d 715
12 Donnell, *supra*

Chapter 20 Summary

When criminal activity is reasonably foreseeable due to known prior criminal activity, the landlord has a duty to take reasonable measures to prevent harm to persons on the property from future similar criminal activities.

A landlord is to properly maintain existing security features on the leased premises. However, the landlord does not have a duty to take control over an adjoining property and remove or prevent injury from dangerous conditions existing on the adjoining property.

Chapter 20 Key Term

reasonably foreseeable .... pg. 200

Chapter 21

Commercial lease agreements

Learning Objectives

After reading this chapter, you will be able to:

- distinguish the various types of commercial lease agreements and use them to meet the objectives of the landlord and tenant;
- recognize the separate provisions of a lease agreement and understand what conduct they control;
- use an offer to lease or a letter of intent to initiate and document negotiations prior to entering into a written lease agreement; and
- determine whether the tenant or the landlord is responsible for paying property operating expenses and attending to the care and maintenance of the leased premises under lease agreement provisions.

Key Terms

ad valorem taxes
attorney fees provision
bona fide purchaser
choice-of-law provision
constructive notice
corporate resolution
eminent domain
entire agreement clause
full-service gross lease
gross lease
heirs, assigns and successors clause
license
net lease
reasonable certainty
reformation action
reversionary interest

The conveyance of a leasehold

A lease agreement is a *contract* entered into by a landlord and tenant setting forth tenant and landlord responsibilities, namely, the payment of money and the care of the real estate.

The lease agreement also acts to convey a possessory interest in real estate, called a **leasehold estate**, or simply referred to as a **lease**.[1]

By entering into a lease agreement and delivering possession of the leased property to the tenant, the landlord conveys to the tenant the exclusive right to occupy a parcel of real estate, or space in a parcel, for a fixed period of time. The continued right to occupancy of the real estate is conditioned on the tenant's performance of their obligations under two sets of provisions in the lease agreement:

- one calls for the payment of rent; and
- the others call for various levels of property maintenance and payment of operating expenses.

reversionary interest
A landlord's temporarily suspended right to occupy property leased to a tenant for the duration of the lease term.

On expiration of the term of the lease, the right of possession to the real estate reverts to the landlord. During the term of the lease, the landlord as the fee owner holds only a **reversionary interest** in the leased parcel or space.

Once the landlord and tenant have entered into a lease agreement and the tenant takes occupancy, the *right of possession* of the leased real estate is controlled by landlord/tenant law, not contract law.

On the other hand, the rent provisions in the lease agreement which evidences the debt the tenant has agreed to pay to the landlord over the term of the lease is controlled by contract law, not landlord tenant law. The landlord may prematurely repossess the real estate by declaring a forfeiture of the tenant's leasehold interest and right of possession when the tenant breaches a material provision in the lease agreement, the nexus between landlord-tenant and contract laws.

Recall from prior chapters that a forfeiture of the right of possession, the lease, does not automatically cancel the underlying lease agreement, the contract. The lease agreement requiring the tenant to pay rent and other amounts for the duration of the term of the lease remains intact and enforceable.

Conversely, the tenant's obligation to pay as agreed in the lease agreement is avoided on a cancellation of the lease agreement prior to expiration of the term of the lease. For example, a landlord's conduct due to their misunderstanding of the forfeiture provision in a notice to quit on a tenant's breach may bring about a *surrender* of the lease.[2]

Validity of the lease agreement form

A lease agreement conveying a term of occupancy exceeding one year needs to be written to be enforceable, a *statute of frauds* requirement.[3]

Provisions in a lease agreement are separated into three categories of activities:

- *conveyance* of the leasehold interest;
- money obligations of the tenant, a debt called *rent*; and

1 Calif. Civil Code §761(3)
2 **Desert Plaza Partnership** v. **Waddell** (1986) 180 CA3d 805
3 CC §1624(a)(3)

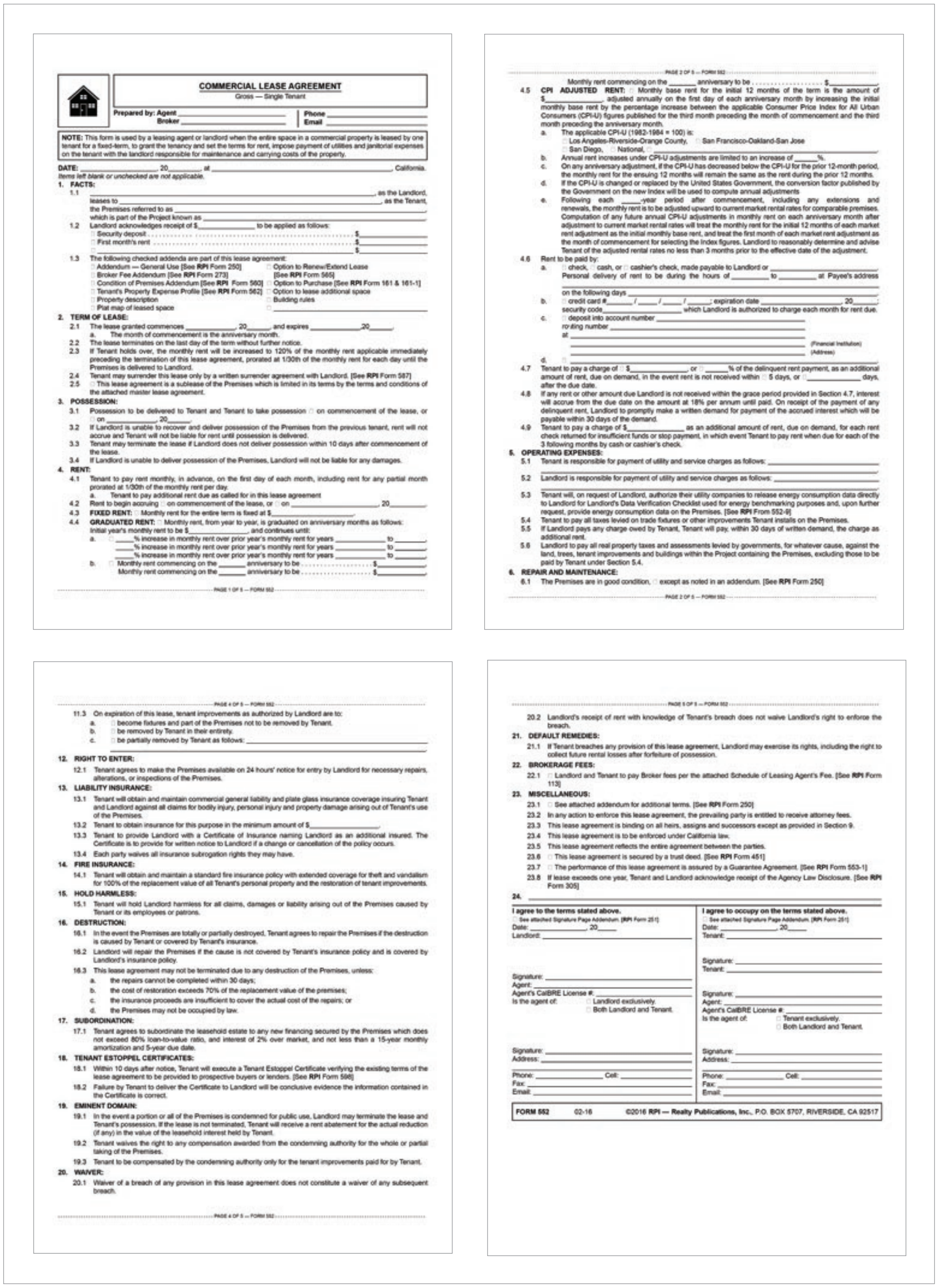

Figure 1

Form 552

Commercial Lease Agreement

Gross — Single Tenant

- responsibility of the tenant and the landlord for care and maintenance of the leased premises and other property operating expenses. [See Figure 1, Form 552]

Editor's note — Many variations of the commercial lease exist. Which of these the landlord and tenant choose depends on the specifics of the tenancy. ***RPI*** *provides gross and net lease agreements tailored to common variations in commercial lease agreements, including:*

- *Single Tenant Gross Lease [See* ***RPI*** *Form 552];*
- *Multi-Tenant Gross Lease [See* ***RPI*** *Form 552-1];*

- *Single Tenant Net Lease [See **RPI** Form 552-2];*
- *Multi-Tenant Net Lease [See **RPI** Form 552-3];*
- *Percentage Lease [See **RPI** Form 552-4]; and*
- *Month-to-Month Tenancy [See **RPI** Form 552-5].*

A landlord and tenant may further customize and modify their lease agreements with different addenda, such as:

- *Maintenance Modification Addendum [See **RPI** Form 552-6];*
- *Alienation Addendum [See **RPI** Form 552-7]; and*
- *Subordination Addendum. [See **RPI** Form 552-8]*

To be valid, a lease agreement:

- designates the *size* and *location* of the leased premises with reasonable certainty;
- sets forth a *term* for the tenancy conveyed; and
- states the *rental amount* and other sums due, and the time, place and manner of payment.[4]

Condemnation conditions in an offer or LOI

A leasing agent, whether they represent the landlord or the tenant, uses either an **offer to lease** or a **letter of intent (LOI)** to initiate and document lease negotiations prior to preparing and entering into a lease agreement. [See **RPI** Form 556]

The preparation and signing of the lease agreement takes place after the terms and conditions of a lease have been negotiated and agreed to in the offer to lease or LOI.

Consider a prospective tenant who signs an offer to lease property. The offer is submitted to the landlord. The offer calls for the landlord to erect a building on the property for use in the tenant's business. The offer does not include an attached copy of a proposed lease agreement nor reference the form to be used. However, the offer to lease does contain:

- a description of the premises to be leased and its location — a building on the premises;
- a lease term — five years; and
- the amount of periodic rent and when it will be paid.

The landlord accepts the offer to lease, agreeing to lease the premises to the tenant. Occupancy is to be delivered on the completion of the improvements by the landlord. The offer to lease also states the tenant will lease the premises for five years, commencing on completion of the improvements. The tenant is to begin making rental payments once the improvements are completed. A formal lease agreement is not prepared or entered into by the landlord and tenant for various reasons.

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4 **Levin** v. **Saroff** (1921) 54 CA 285

After construction of the building is complete, the tenant takes possession. Monthly rental payments are made to the landlord when due.

Both the landlord and the tenant perform according to the terms stated in the offer to lease, except for their failure to enter into the lease agreement.

Later, the property becomes the subject of an *inverse condemnation* action. Persons with an interest in the property, including the tenant, are entitled to share in the money paid by the government agency for the taking of the property.

The landlord claims the tenant is not entitled to any amount from the condemnation award since there is no lease agreement which memorializes the tenant's interest in the property.

The tenant claims they have a leasehold interest in the property under the offer to lease and delivery of possession. Further, the tenant claims they are entitled to recover the value of their lost leasehold interest in the property resulting from the condemnation of the property.

Here, the tenant will participate in the condemnation award; they hold a leasehold interest in the property that was not limited by agreement. The written agreement entered into by the landlord and the tenant — an offer to lease on the terms stated — becomes the lease agreement when the tenant takes possession of the premises without entering into a formal lease agreement.[5]

The *agreement to lease* (the offer or LOI) signed by the landlord contained all the essential terms needed to create a lease. Since all the elements necessary to create a lease are agreed to in writing, the landlord's act of delivering possession to the tenant conveys the agreed five-year leasehold interest to the tenant.

To record or not to record

A lease agreement need not be recorded. Between the landlord and the tenant, and all other parties who have actual or constructive knowledge of the lease, the agreement is enforceable whether or not it is recorded.[6]

An unrecorded lease agreement with a term exceeding one year in length is only unenforceable against a new owner if the new owner qualifies as a **bona fide purchaser**.[7]

bona fide purchaser
A buyer of leased real estate who lacks knowledge that a lease agreement exists and purchases the property for valuable consideration or accepts the real estate as security for a debt.

To qualify as a *bona fide purchaser*, the buyer needs to:

- lack knowledge the lease agreement exists; and
- purchase the leased real estate for valuable consideration or accept the real estate as security for a debt (foreclosure).

Regardless of whether the lease agreement is recorded, the buyer is charged with the knowledge of the tenant's leasehold interest if the tenant occupies

5 **City of Santa Cruz** v. **MacGregor** (1960) 178 CA2d 45
6 CC §1217
7 CC §1214

constructive notice
To be charged with the knowledge observable or recorded conditions exist on the property. When a tenant occupies a property under a lease agreement, a buyer is charged with constructive notice of the tenant's leasehold interest by the occupancy.

the property at the time it is purchased. The tenant's occupancy puts the purchaser on **constructive notice** a lease (or some other arrangement with the occupant) exists.[8]

However, when a lease agreement is recorded, the content of the recorded agreement may be relied on by a purchaser as a statement of all the rights of the tenant.

Editor's note — The above rules also apply to lenders when the landlord uses the property as security for a mortgage.

Also, if the lease agreement is recorded but the tenant holds an unrecorded option to buy the leased property or extend the lease, the option cannot be enforced against a buyer or lender who later acquires an interest in the property if:

- *the buyer or lender had no actual knowledge of the option at the time of acquisition; or*
- *the unrecorded options are not referenced in the recorded lease.*[9]

The contents of a lease agreement

A commercial lease agreement form has five main sections:

- identification of the parties and the premises, and the conveyance and term of the lease;
- the terms for payment of rent and other amounts owed, collectively called the **rent provisions**;
- the provisions setting forth the responsibility for care and maintenance of the leased property, collectively called **use-maintenance provisions**;
- miscellaneous provisions for circumstances unique to the transaction; and
- the signatures of the parties.

The identification section of a real estate lease agreement contains facts:

- the names of the landlord and the tenant;
- a description of the leased premises;
- words of conveyance of the leased property;
- a receipt for prepaid rents and the security deposit; and
- a list of the addenda which contain exhibits or additional terms. [See Form 552 §1.1-1.3]

The leasehold conveyance

The lease agreement includes words of transfer by which the landlord conveys — grants — a leasehold interest in the property to the tenant. [See Form 552 §1.1]

8 **Manig** v. **Bachman** (1954) 127 CA2d 216
9 **Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356

The conveyance of a lease is typically achieved with the words "landlord... leases to...tenant the real estate referred to as..." [See Form 552 §1.1]

License or lease?

Consider the landlord of a department store who enters into an agreement with a tenant to occupy space in the store for three years. The tenant will use the space to conduct their business.

The agreement states the space to be occupied by the tenant will be designated by the landlord at the time of occupancy.

The agreement also:

- outlines the formula for the monthly rent to be paid for the space;
- gives the tenant the sole and exclusive right to conduct their business in the store without competition;
- restricts transfer of the tenant's right to occupy the space without the landlord's consent; and
- requires the tenant to surrender the occupied premises on the last day of the rental term.

The tenant takes possession of the space designated by the landlord. Before the term for occupancy expires, the landlord notifies the tenant they are terminating the agreement and the tenant is to vacate the premises. The tenant does not comply with the landlord's notice to quit.

As a result, the landlord removes the tenant's fixtures, equipment and inventory, and bars the tenant from entering the premises.

The tenant claims the landlord can neither terminate the occupancy nor remove their possessions without first filing a UD action and obtaining a judgment to recover possession. The occupancy agreement constitutes a lease which conveyed a leasehold interest in the occupied space to the tenant which needs to terminate before the tenant has to vacate.

The landlord claims the occupancy agreement is a mere **license** to conduct business in the store. It is not a lease since no defined space was described in the agreement to identify the location of the leased premises.

license
The personal, unassignable right held by an individual to the non-exclusive use of property owned by another.

Here, the agreement to occupy the space conveyed a leasehold interest in the space provided for the tenant to occupy, not a *license* to use. While the agreement itself does not identify the space to be occupied by the tenant or contain words of conveyance, the agreement becomes a lease on the tenant's occupancy of the premises designated by the landlord since the agreement states:

- possession of the premises is to be delivered to the tenant for their *exclusive use* in exchange for monthly rent;
- assignment of the lease calls for the *prior consent* of the landlord; and

- the premises need not be delivered up to the landlord until expiration of the right of occupancy.[10]

The agreement entered into by the landlord does not contain the words "landlord...leases to...tenant" as words of conveyance. However, the contents of the agreement indicate the landlord's intention to convey a leasehold estate to the tenant, not create a license to use.

Sale disguised as a lease

Conversely, an occupancy agreement does not automatically convey a lease just because it uses words of leasehold conveyance. The economic function of a "lease transaction" may actually be something quite different, that of a sale which has been recharacterized by the parties under the guise of a lease.

For instance, a lease-option agreement that allocates option money or a portion of each rental payment, or both, toward the purchase price or down payment set for the purchase of the property is not a lease at all. The lease-option agreement is a disguised security device for executing an installment sale since it evidences a credit sale by a carryback seller.

Taxwise, the lease-option agreement is a sale requiring the seller (the "landlord", in this scheme) to report any profit in the down payment when the monies are received. Since this is a sale, the down payment cannot be deferred as option money under option rules.[11]

Proper identification of the parties

Each party to a lease agreement needs to be properly identified. On the lease agreement form, the identification of the tenant indicates how their ownership of the lease conveyed will be vested. Ownership of the lease can be vested as:

- community property;
- community property with right of survivorship;
- joint tenancy;
- tenancy-in-common;
- sole ownership;
- a trustee for themselves or for someone else; or
- a business entity.

When the ownership interest of the landlord is community property, both spouses need to consent to agreements leasing the community property for a fixed term exceeding one year. If not, the community is not bound by the lease agreement. Also, if challenged within one year after commencement by the nonconsenting spouse, the tenant cannot enforce the conveyance of the leasehold interest.[12]

10 **Beckett** v. **City of Paris Dry Goods Co.** (1939) 14 C2d 633

11 **Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798

12 Calif. Family Code §1102

Business entities as owner or tenant

In addition to individuals, **business entities** which may own or lease property include:

- corporations and out-of-state entities qualifying as a corporation such as business trusts;
- limited liability companies (LLCs);
- partnerships, general or limited;
- real estate investment trusts (REITs);
- nonprofit organizations; and
- governmental agencies.

When the landlord or tenant is a partnership or LLC, the lease agreement indicates:

- whether the partnership is a limited (LP), general (GP) or limited liability partnership (LLP);
- the partnership's or LLC's state of formation, and if out of state, whether it is qualified to do business in California; and
- the name of the partners or members authorized to bind the partnership.

With information on the partnership or LLC, the landlord and any title company insuring the leasehold can review recorded documents to confirm the authority of the general or managing partner or managing member to bind the partnership or LLC.

Whether a corporation is the landlord or tenant, the full corporate name and the state of incorporation needs to be stated. Also included is the name and title of the officer who will be signing the lease agreement as the agent committing the corporation to the lease agreement.

The corporate information will allow for confirmation of:

- the corporation's good standing to operate in the state; and
- the officers registered with the state to act on behalf of and bind the corporation under resolution by the corporation's board of directors.

Premises identified with certainty

The commercial lease agreement describes the premises to be leased sufficiently to be located with **reasonable certainty**. A description is *reasonably certain* if it furnishes a "means or key" for a surveyor to identify the parcel's location.[13]

reasonable certainty
The degree of certainty expected from a reasonable person.

If the premises is a building or a space in a building, the common street address, including the unit number, is a sufficient description to identify the premises.

If the premises is not easily identified by its common address, a plot map or floor plan needs to be included as an addendum to the lease agreement. The

13 **Beverage** v. **Canton Placer Mining Co.** (1955) 43 C2d 769

Case in point

A sufficient description

A tenant signs and hands a landlord an offer to lease together with the proposed lease agreement for space in a retail commercial center. Attached to the proposed lease agreement is a plot plan outlining the location of the leased premises.

The lease agreement contains a provision requiring the landlord to provide the exact legal description of the premises as an addendum to the lease agreement. The landlord is to deliver this addendum no sooner than 30 days after the leased premises is occupied by the tenant.

After submitting the offer to lease, the tenant decides to lease space at another location. The tenant mails a revocation letter to the landlord for the withdrawal of their offer.

However, the tenant receives the signed offer and lease agreement from the landlord before the landlord receives the tenant's revocation letter. The lease agreement does not include a copy of the plot plan addendum that was attached to the proposed lease.

The tenant refuses to perform under the lease agreement, claiming the lease agreement is unenforceable since the landlord failed to deliver the plot plan addendum that designated the size of the leased premises.

The landlord seeks to enforce the tenant's performance of the lease agreement.

*Here, a lease has been entered into which is enforceable. The precise size of the leased premises is not crucial to the lease transaction since the location of the premises is known due to the plot plan attached to the proposed lease agreement. Also, the lease agreement states the exact size of the premises identified on the plot plan will be determined after the tenant takes possession. [**Mabee** v. **Nurseryland Garden Centers, Inc.** (1978) 84 CA3d 968]*

space to be rented is highlighted or otherwise identified. A plot map or floor plan eliminates confusion over the location of the leased parcel or space in the building, and initially establishes the parameters of the leased space.

An attached floor or plot plan noting square footage is useful when rent is calculated based on square footage occupied by the tenant, or on the percentage of square footage within a project leased to the tenant.

However, an inaccurate or incomplete description of the leased premises will not prevent a landlord from conveying, and the tenant from accepting, a leasehold interest in a parcel of real estate. When the premises described in a lease agreement is incomplete or inaccurate, the tenant's actual possession of the premises will set the boundaries.[14]

Further, an incomplete or inaccurate description of the leased premises which the tenant has occupied does not release a tenant from liability under the lease for the space they actually occupied.[15]

Addenda to the lease agreement

Terms common to commercial lease agreements are contained in the provisions of a regular form. [See **RPI** Form 552—552-5]

14 Beckett, *supra*

15 City of Santa Cruz, *supra*

Addenda to the lease agreement

However, the terms and conditions peculiar to the leasing of a particular type of commercial tenancy, such as commercial, industrial, office, farming operation or hotel, or provisions unique to the parties and their advisors, are handled in an addendum attached to the lease agreement.

The use of an addendum to house extraordinary and atypical provisions not in common use prevents a later surprise.

Also, any handwritten or typewritten provisions added to an agreement control over conflicting pre-printed or boilerplate provisions. When inconsistencies arise between provisions in the pre-printed lease agreement form and an attached addendum, the provisions in the addendum control.[16]

The use of addenda for making changes or additions to leasing provisions allows parties to tailor the lease agreement to meet their unique needs.

Addenda occasionally attached to a commercial lease agreement include:

- terms unique to the type of property leased;
- a property description addendum, such as a plot map or site plan;
- a structural or tenant improvement agreement;
- a condition of premises addendum [See Form 560 in Chapter 36];
- a maintenance modification addendum [See **RPI** Form 552-6];
- an alienation addendum [See **RPI** Form 552-7];
- a building rules addendum;
- an option or right of first refusal to renew or extend [See **RPI** Form 566];
- a brokerage fee addendum [See **RPI** Form 273];
- a tenant leasehold subordination agreement regarding a future mortgage [See **RPI** Form 552-8];
- a non-disturbance and attornment provision;
- a signage or tenant association agreement;
- an option or right of first refusal to lease additional space [See **RPI** Form 579-1];
- authority to sublease or assign; and
- an option or right of first refusal to buy. [See **RPI** Form 161 and Form 579 in Chapter 6]

If the lease agreement is for a sublease of the premises, a copy of the master lease is referenced in and attached to a regular lease agreement thus creating a sublease. [See Form 552 §2.5]

The term of the tenancy

A commercial lease agreement is an agreement to rent real estate for a **fixed term**, as opposed to a periodic rental term. Thus, the lease agreement indicates the dates the lease term commences and expires.[17] [See Form 552 §2.1]

16 **Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636
17 CC §761(3)

Form 113

Schedule of Leasing Agent's Fee

SCHEDULE OF LEASING AGENT'S FEE

NOTE: This form is used by a leasing agent as an addendum when entering into a listing agreement or preparing a letter of intent (LOI), offer to lease or lease agreement, to set their fee due on the lease agreement and on any modification, extension or renewal of the lease agreement or purchase of the premises by the tenant.

DATE: ____________, 20_____, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
☐ Lease Agreement [See **RPI** Form 550 and 552] ☐ Rental Agreement [See **RPI** Form 551]
☐ Offer to Lease [See **RPI** Form 556] ☐ Exclusive Authorization to Lease Property [See **RPI** Form 110]
☐ Exclusive Authorization to Locate Space [See **RPI** Form 111]
1.1 dated ______________________, 20 _________, at ______________________________, California,
1.2 entered into between ____, as the Landlord, and
1.3 ______________________________, as the _______________________________________.
1.4 regarding real estate referred to as ____.

2. Fees due and payable to Broker by Landlord under the above referenced agreement include:
2.1 Leasing agent's fees on the initial lease of the premises in the following amounts:
a. For leases with a term of five years or less:
1. ______% of the total rent for the first year;
2. ______% of the total rent for the second year;
3. ______% of the total rent for the third year;
4. ______% of the total rent for the fourth year; and
5. ______% of the total rent for the fifth year.
b. For leases with a term of more than five years:
1. ______% of the total rent for the first five years;
2. ______% of the total rent for the second five years; and
3. ______% of the total rent for the remaining years.
2.2 Leasing agent's fees on any modification, extension, renewal, new lease or other leasehold arrangement for the continuing occupancy by Tenants, or Tenant's successors or agents, of the property or any other property owned or controlled by Landlord or Landlord's successors, in the amounts calculated under the fee schedule in paragraph 2.1 above, as though the occupancy was a continuation of the original lease.
2.3 A brokerage fee on the acquisition of ownership by Tenant, or Tenant's successors or agents, of any property which is the subject of a leasing agent's fee, in the following amounts:
a. ______% of the first $______________ of the purchase price paid by Tenant;
b. ______% of the next $______________ of the purchase price paid by Tenant; and
c. ______% of the balance of the purchase price paid by Tenant.

3. Fees due and payable to Broker by Tenant under the above referenced agreement include:
3.1 Fees due Broker under paragraphs 2.2 and 2.3 on Tenant's renewal or extension of their occupancy and acquisition of ownership of the property if Tenant, during Tenant's continuing occupancy of the property, renews or extends their occupancy or acquires ownership of the property from a party other than Landlord or Landlord's successors bound by paragraphs 2.2 and 2.3 above.

4. Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee ☐ ___________ : ______________
or ☐ ____.

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ______________, 20_____
Landlord's Broker: __________ CalBRE #: _________

Signature: _______________________________
Tenant's Broker: ___________ CalBRE #: _________

Signature: _______________________________
Phone: __________________ Cell: ____________
Email: _________________________________

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ______________, 20_____
Landlord: ____________________________

Signature: ___________________________
Tenant: ______________________________

Signature: ___________________________
Phone: ____________ Cell: ____________
Email: _______________________________

FORM 113 07-14

The date for delivery and acceptance of possession are addressed separately from the date of the lease agreement. Further, the date given at the top of a lease agreement is for the purpose of identifying the document. [See Form 552 §3.1]

On expiration of the lease term on the date stated in the lease agreement, the tenant's right of possession automatically terminates. The tenant vacates the property on the lease expiration date unless further occupancy agreements exist. No further notice is required from the landlord or tenant to terminate the tenancy or to vacate.[18]

Recall that a *holdover tenancy* is created when:

- the tenant remains in possession after the lease term expires without a right to renew or extend the tenancy; and
- the landlord refuses to accept further rent payments.

The holdover tenancy ends when the tenant vacates or is evicted.

Holdover provision

The lease agreement contains a holdover rent provision calling for a set dollar amount of rent due for each day the tenant holds over. The holdover rent is due and payable when the tenant vacates or is evicted, not before. The daily rent rate is usually significantly higher than the fair market rate. As a result, holdover rent is considered unreasonable in a UD action. UD actions typically allow only market rent rates for the holdover period. [See Form 552 §2.3]

If the amount of holdover rent is not set in the lease agreement, a fair market rate will be recoverable during the holdover (which is also the ceiling for rent awarded in a UD action to evict the holdover tenant).

The landlord may initiate UD proceedings to evict the holdover tenant immediately on expiration of the tenant's right to possession.[19]

Delivery and acceptance of possession

Lease agreement provisions set the date the tenant will take possession of the leased premises. The agreement also address the consequences when a landlord fails to deliver the premises to the tenant as agreed. [See Form 552 §3.2]

The tenant is given the opportunity to terminate the lease agreement if possession is not delivered within an agreed-to number of days after commencement of the lease. [See Form 552 §3.3]

A landlord sometimes fails to deliver possession to the tenant due to their inability to recover the premises from a previous tenant. For the tenant to cover this risk, the lease agreement states the tenant is not liable for rent payments until possession is delivered. [See Form 552 §3.2]

Conversely, the lease agreement states the landlord will not be liable for damages if they are unable to deliver possession. [See Form 552 §3.4]

Eminent domain

A tenant may contract away their right to receive any compensation awarded to the landlord in a condemnation action by a government agency to take the real estate (fee and leasehold), also known as **eminent domain**.[20]

18 CC §1933
19 CCP §1161(1)
20 **New Haven Unified School District** v. **Taco Bell Corporation** (1994) 24 CA4th 1473

Commercial leases typically reserve for the landlord all rights to any condemnation award. This reservation is made under the *eminent domain* provision. [See Form 552 §19]

eminent domain
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

Also, the landlord may reserve their right to terminate the lease in the event of a partial condemnation. If the landlord does not choose to terminate the lease when a partial taking occurs, the tenant is entitled to rent abatement for the reduction in value of their leasehold interest. [See Form 552 §19.1]

A tenant under a lease has a right to receive compensation for their leasehold interest if their lease is terminated due to a condemnation proceeding.[21]

However, if a lease provision eliminates the tenant's rights to any compensation awarded to the landlord, the tenant looks to the condemning authority to recover other losses, such as:

- relocation costs;
- loss of goodwill;
- bonus value of the lease (due to below market rent); or
- severance damages when a partial taking occurs.

Brokerage fees

Initially, the responsibility for assuring payment of a broker fee for leasing services is controlled by employment provisions in:

- an *authorization to lease*;
- an authorization to locate space [See **RPI** Form 111]; or
- a *property management agreement*.

Secondly, the payment of fees is controlled by the placement of a brokerage fee provision within the tenant's *offer to lease* or *LOI* signed by the tenant.

Lastly, a provision for payment of the broker fees is included in the lease agreement. This redundancy allows the broker to enforce payment of the brokerage fees in case the prior documents did not include a commitment from either the tenant or the landlord to pay the brokerage fees. Also, fee arrangements are negotiable and change between the initial employment and signing of a leasing agreement. [See Form 552 §22 and Form 113 accompanying this chapter]

Miscellaneous provisions

An **attorney fee provision** is essential in a lease agreement if the landlord is to recover costs incurred to enforce payment of rent or evict the tenant. Regardless of how an *attorney fee provision* is written, the prevailing party is entitled to their fee.[22] [See Form 552 §23.2]

attorney fees provision
A provision in an agreement permitting the prevailing party to a dispute to receive attorney fees when litigation arises due to the agreement. [See **RPI** Form 552 §23.2]

21 CCP §1265.150
22 CC §1717(a)

The **heirs, assigns and successors clause** binds those who later take the position of the landlord or tenant to the existing lease (or rental) agreement through a(n):

- grant;
- assignment; or
- assumption.[23] [See Form 552 §23.3]

heirs, assigns and successors clause
A clause in a lease agreement which binds those who later take the position of landlord or tenant to the existing agreement. [See **RPI** Form 552 §23.3]

A **choice-of-law provision** in the lease agreement assures application of California law when a dispute arises between the tenant and the landlord. [See Form 552 §23.4]

choice-of-law provision
A provision specifying California law applies if a dispute arises with a tenant regarding the lease. [See **RPI** Form 552 §23.4]

Application of California law in disputes over property located in California adds stability to the legal expectations of the landlord and tenant. It also produces greater commercial certainty in real estate transactions and stabilizes property values.

Additionally, the lease agreement reflects the entire agreement between the parties and is best modified only in writing.

An **entire agreement clause** serves two key purposes. The objective is to avoid disputes over "just what are" the terms of the lease agreement resulting from negotiations to enter into or modify the agreement. An *entire agreement clause* limits the ability for the tenant or the landlord:

- to imply terms into the lease based on oral statements made before entering into the lease agreement; and
- to later orally modify terms of a lease agreement. [See Form 552 §23.5]

entire agreement clause
A clause in a lease agreement which limits the tenant's ability to imply terms into the lease based on oral statements made before entering into the lease. [See **RPI** Form 552 §23.5]

Performance assurance provisions address the tenant's performance of their lease obligations, including:

- security for lease agreement obligations provided by a trust deed encumbering real estate owned by the tenant (or others) [See **RPI** Form 451; see Form 552 §23.6]; and
- guarantees given by a corporate tenant's officer or another person. [See **RPI** Form 553-1; see Form 552 § 23.7]

If the tenant fails to pay rent or otherwise breaches the lease, the landlord may evict the tenant. Then, after a demand for payment, the landlord may foreclose under the performance trust deed to recover rent due, attorney fees and costs of the trustee's sale.[24]

Signatures on behalf of the parties

Individuals who sign a lease agreement on behalf of the landlord or the tenant need to have the capacity and the authority to act on behalf of and bind the landlord or tenant.[25]

23 **Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309
24 **Willys of Marin Company** v. **Pierce** (1956) 140 CA2d 826
25 CC §§2304; 2307

Sidebar

Americans with Disabilities Act (ADA) disclosure

All commercial rental and lease agreements include an ***Americans with Disabilities Act (ADA)*** *disclosure. Without it, landlords expose themselves to tenant litigation for fraud (or indemnity) when the tenant is hit with an ADA violation claim. [See Figure 1, Form 552 §7.6 and 7.9]*

An ADA risk compliance disclosure provision is included in ***RPI's*** *commercial lease agreements. California's Disabled Access Law makes disclosure of ADA conditions a* ***material fact.***

To avoid misrepresenting property conditions, a commercial lease agreement needs to declare whether the property has undergone an inspection by a Certified Access Specialist (CASp). Further, if the property has been inspected, a statement whether it does or does not meet ADA standards is included. [See Figure 1, Form 552 §7.9]

While the landlord needs to disclose ADA conditions, they need not obtain a CASp inspection. It is the failure to make ADA disclosures, as with code violations, which exposes the landlord to claims of fraud. [Calif. Civil Code §1938 and §55.53]

Unless the landlord is aware that the persons signing do not have authority to enter into a lease on behalf of the corporation, the lease entered into by a corporate tenant is valid if it is signed by:

- the chairman of the board, president or the vice president; and
- the secretary, assistant secretary, chief financial officer or assistant treasurer.[26]

corporate resolution
A document from a corporation's board of directors which gives the officers of a corporation the authority to sign and bind the corporation to a lease.

However, a **corporate resolution** is the best evidence of the corporate officers' authority to act on behalf of the corporate tenant. A *corporate resolution* is a document from a corporation's board of directors which gives the officers of a corporation the authority to sign and bind the corporation to a lease.[27]

When an LLC or LLP enters into a lease agreement, the manager signing on behalf of the LLC or LLP needs to be the person named as the manager in the LLC-1 or LLP-1 certificate filed with the Secretary of State and recorded with the local county recorder.

However, an LLP or an LLC will still be bound to a lease agreement if:

- a partner or member, other than the general partner or manager, signs the lease agreement; and
- the landlord believes the partner or member is acting with the authority of the entity due to their title as chairman or president.[28]

The economics of commercial leases

Commercial lease agreements are used in transactions involving industrial, commercial, office and other types of commercial income-producing property.

A tenant who acquires a leasehold interest in commercial real estate agrees to be obligated for none, some or all of the **operating costs** of the real estate incurred directly or paid as additional rent. These obligations are in addition to payment of the base rent and periodic adjustments to the rent.

26 Corp C §313
27 Calif. Corporations Code §300
28 Corp C §17154(c)

Editor's note — Residential lease agreements generally do not require the tenant to undertake the full care and maintenance of the premises. Usually, residential tenants only have the duty to prevent excessive wear and tear.

Typically, the longer the term of the commercial lease, the more extensive the shift of ownership costs and responsibilities to the tenant, including:

- property operating expenses;
- all or future increases in real estate taxes, called **ad valorem taxes**;
- hazard insurance premiums;
- repair and maintenance of the improvements; and
- the risk of an increase in interest payments on an adjustable rate mortgage encumbering the property.

When a long-term lease obligates the tenant to pay for all expenses incurred in the ownership and operation of the property, the tenant incurs the expenses in one of two arrangements:

- directly, the tenant contracting for services and paying the costs, including payment of property taxes and insurance premiums; or
- indirectly, the landlord incurring operating expenses and in turn billing the tenant for payment, commonly called *common area maintenance charges (CAMs)*.

The responsibility for the payment of operating costs is reflected by the titles given to commercial lease agreements as either:

- a **gross lease**; or
- a **net lease**.

ad valorem taxes
Real estate taxes imposed on property based on its assessed value. [See **RPI** Form 552-2 §5.1]

gross lease
A commercial lease specifying that the tenant pays for their utilities and janitorial fees, but unless modified is not responsible for any other care, maintenance or carrying costs of the property. [See **RPI** Form 552 and 552-1]

net lease
A commercial lease which transfers to the tenant the obligation, unless modified, to pay all of the costs of ownership in addition to utilities and janitorial services. [See **RPI** Form 552-2 and 552-3]

Lease variations

Variations and modifications exist for both types of lease agreements provided by addendums. For example, a gross lease calling for the tenant to pay some of the operating expenses is called a **modified gross lease.** When the landlord enters into a net lease agreement and retains responsibility for some of the operating expenses, the lease is called a **modified net lease**.

A commercial lease is typically called a *gross lease* if the tenant pays for their utilities and janitorial fees, but is not responsible for any other care, maintenance or carrying costs of the property.

When the landlord of an office building retains the responsibility for payment of all costs of care and maintenance, including the tenant's utilities and janitorial services, the gross lease is referred to as a **full-service gross lease**. [See **RPI** Form 552 and 552-1]

Conversely, a commercial lease that transfers to the tenant the obligation to pay some or all of the costs and responsibilities of ownership, in addition to utilities and janitorial services, is referred to as a *modified gross lease* (or a *modified net lease* if the tenant is obligated for most operating expenses). [See **RPI** Form 552-2 and 552-3]

full-service gross lease
A commercial lease specifying that the landlord retains the responsibility for payment of all costs of care and maintenance, unless modified, including the tenant's utilities and janitorial services. [See **RPI** Form 552 and 552-1]

Sidebar

Agent Survey Sheet for Commercial Property

A leasing or buyer's agent enters into an employment agreement with a user-client as the client's representative to locate and negotiate a lease or purchase commercial space to house their business operations. On determining the client's space requirements, the agent turns to the task of collecting information on available properties. From the data assembled, qualifying properties most likely to satisfy the client's needs are identified.

Here, when a leasing agent seeks out information on available properties the issue becomes: "what is the best way to quickly gather pertinent details on available properties for later analysis?"

*The answer lies in the use of a **quick-fact** checklist to itemize the types of data and information required on a property to determine its suitability for the client's need for space. One such itemized checklist is the* **Agent Survey Sheet for Commercial Property***. [See **RPI** Form 320-3]*

*The Agent Survey contains a series of questions to be asked of the owner's agent, or the owner if the property is not listed with a broker. Armed with detailed information on available properties, the agent and their user-client can determine which of the available properties best meets the client's needs. At this point, enough is known about a property to determine whether or not to submit a **letter of intent (LOI)** or an offer to lease or buy, and if so, on what terms. Essentially, the survey is used as a prudent **risk mitigation** practice for the broker. [See **RPI** Form 556]*

The Agent Survey Sheet for Commercial Property contains probing questions relating to:

- *the usable square footage of the improvements and the lot and its age;*
- *facilities within the improved space including the number of bathrooms, and descriptions of the kitchen and breakroom/staff lounge;*
- *warehouse specifications, including usable square footage, ceiling clearance height, type of flooring and type of lighting;*
- *asking rent amount or base rent sought;*
- *move-in incentives offered by the owner;*
- *whether the owner or tenant pays the property taxes, insurance premiums, and like items;*
- *a description of the property's surrounding area;*
- *problems with vandalism or crime reported in the area, known earthquake faults and seismic hazards, or noise nuisances; and*
- *a description of the existing internet connections and phone lines, existing energy efficiency improvements and the ENERGY STAR® Energy Performance Score.*

*The Agent Survey Sheet for Commercial Property functions as a thorough **quick-reference guide**. By using it, the agent has compiled and considered all the advantageous and adverse information on a property in a single document. It makes for an easy, focused review by the agent and the user-client.*

A lease becomes more net (and less gross) as the landlord shifts ownership responsibilities and operating costs to the tenant.

Reformation of the lease agreement

During lease negotiations, a landlord orally assures a tenant they will enter into a lease for an initial term of five years with two five-year options to renew. The landlord and tenant do not memorialize the offers to lease or LOIs in writing.

However, the lease agreement the landlord prepares and hands to the tenant sets the lease term at 15 years. Without reviewing the lease agreement, the tenant signs the lease agreement and takes possession of the premises.

The business operated by the tenant on the leased premises later fails, and the tenant defaults on the rent payments. The tenant then discovers for the first time the length of the lease term is 15 years. The landlord seeks to collect the unpaid rent for the 15-year period under the lease agreement (subject to any mitigation and present-worth discounting).

Reformation of the lease agreement, cont'd

The tenant seeks to rescind the lease agreement due to the landlord's oral misrepresentation about the length of the lease term. The tenant claims the lease provisions contradict the oral agreements between the landlord and the tenant which predated the lease agreement.

Can the tenant rescind the lease agreement?

No! The landlord's oral representations regarding the lease term prior to execution of the lease agreement do not render the lease unenforceable. The terms set forth in the written lease agreement control over prior oral understandings.[29]

Rescission of lease agreements is rare since intentional misrepresentation or other fraud in the inducement is required to be shown by the tenant. As an alternative remedy, the tenant in this scenario may pursue a **reformation action** to alter the terms of the written lease agreement to conform to the terms of the oral agreement.

reformation action
A court action by a tenant seeking to reform the terms of a lease agreement to include prior agreements, oral or written, intended to be part of the lease agreement.

Another reason for reformation of lease provisions arises when a significant difference exists between the square footage contained in the leased space and the square footage given in the lease agreement for calculating rent.

29 **West** v. **Henderson** (1991) 227 CA3d 1578

Chapter 21 Summary

A lease agreement is a contract entered into by a landlord and tenant addressing the tenant's primary responsibilities: the payment of money and the care of the real estate. The lease agreement also acts to convey a possessory interest in real estate to the tenant. By entering into a lease agreement and delivering possession to the tenant, the landlord conveys to the tenant the exclusive right to occupy a parcel of real estate, or space in a parcel, for a fixed period of time. On expiration of the term of the lease, the right of possession to the real estate reverts to the landlord.

The provisions contained in a written lease agreement fall into one of three categories of activities:

- conveyance of the leasehold interest;
- the money obligation of the tenant, a debt called rent; and

- responsibility of the tenant and the landlord for care and maintenance of the leased premises and other property operating expenses.

A broker, whether they represent the landlord or the tenant, uses either an offer to lease or a letter of intent (LOI) to initiate and document lease negotiations prior to entering into the lease agreement itself. The preparation and signing of the actual lease agreement remains to be done after its terms and conditions have been negotiated and agreed to in the offer to lease.

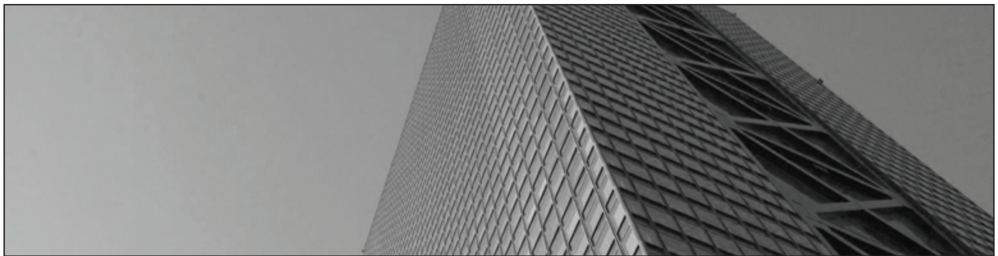
A commercial lease agreement form has five main sections:

- identification of the parties and the premises, and the conveyance and term of the lease;
- the terms for payment of rent and other amounts owed, collectively called rent provisions;
- the provisions setting forth the responsibility for care and maintenance of the leased property, collectively called the use-maintenance provisions;
- miscellaneous provisions for circumstances specific to the transaction; and
- the signatures of the parties.

A lease agreement conveying a term of occupancy exceeding one year is required to be written to be enforceable.

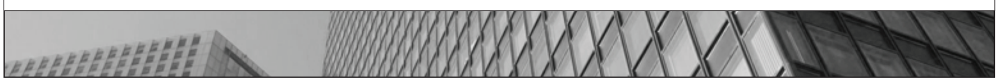
Chapter 21 Key Terms

ad valorem taxes .... **pg. 221**
attorney fees provision .... **pg. 218**
bona fide purchaser .... **pg. 209**
choice-of-law provision .... **pg. 219**
constructive notice .... **pg. 210**
corporate resolution .... **pg. 220**
eminent domain .... **pg. 218**
entire agreement clause .... **pg. 219**
full-service gross lease .... **pg. 221**
gross lease .... **pg. 221**
heirs, assigns and successors clause .... **pg. 219**
license .... **pg. 211**
net lease .... **pg. 221**
reasonable certainty .... **pg. 213**
reformation action .... **pg. 223**
reversionary interest .... **pg. 206**



Chapter 22

Rent provisions in commercial leases



Learning Objectives

After reading this chapter, you will be able to:

- understand the rent provisions in a regular lease agreement, such as the dollar amount of the rent, and the time, place and manner of payment;
- distinguish fixed-rent provisions from adjustable, graduated and percentage rent provisions, and describe the attributes of each;
- identify the rent provisions which periodically adjust a tenant's rent; and
- negotiate the operating costs to be paid by the tenant in addition to rent in long-term commercial leases.

Key Terms

base rent

percentage lease

fixed-rent lease

Setting the rent

Various rent formulas exist to meet the financial needs of landlords and tenants. All commercial lease agreements set a minimum amount of monthly rent to be paid by the tenant. This minimum monthly rent is called **base rent**. [See **RPI** Form 552 §4.4]

Typically, the *base rent* is the monthly amount paid during the first year of the lease (with the exception of *percentage leases*). [See **RPI** Form 552-4]

However, in many short-term leases (e.g. leases of two to five years), the base rent is paid during the entire term of the lease, without an adjustment.

A lease agreement which sets monthly rent payments at a specific dollar amount over the entire life of the lease results in what is called a **fixed-rent lease**. [See **RPI** Form 552 §4.3]

base rent
The minimum monthly rent due under a commercial lease agreement. [See **RPI** Form 552 §4.3]

fixed-rent lease
A lease agreement with monthly rent payments set at a specific dollar amount for the life of the lease. [See **RPI** Form 552]

In a rising local economy or period of general price inflation, a long-term *fixed-rent lease* will prove to be a financial disaster for the landlord. Fixed rent shifts the inflation hedge appreciation in the property's value to the tenant for so long as the fixed rent continues.

However, a landlord may be forced to accept fixed-rent leases during economic downturns or static rental markets when interest rates are anticipated to rise in the future. To avoid a potential loss of return under a fixed-rate lease during an economic recovery, the landlord needs to consider negotiating a short-term lease or month-to-month tenancy.

percentage lease
A commercial lease agreement for a retail operation that sets the total amount of rent the tenant will pay as a percentage of the tenant's gross sales. [See **RPI** Form 552-4]

When leasing space in larger, multi-tenant retail properties, landlords often negotiate a rent provision that calculates the total amount of rent the tenant will pay annually as a percentage of the tenant's gross sales. This type of lease is called a **percentage lease**. [See **RPI** Form 552-4]

Under a *percentage lease*, the tenant pays the greater of the base rent or the percentage rent. [See **RPI** Form 552-4]

Periodic rent adjustments

Many commercial lease agreements contain provisions under which the base rent is adjusted periodically, usually on each anniversary of the lease commencement date and again every three to five years. Price adjustment provisions include:

- an *inflation-adjusted rent provision* which adjusts for annual price inflation as measured by the Consumer Price Index (CPI) [See **RPI** Form 552 §4.5];
- a *graduated rent provision* which annually adjusts rents upward in set percentage or dollar amounts; and
- an *appreciation-adjusted rent provision*, which adjusts the base rent every five years or so for property appreciation in excess of inflation due to changes in local market conditions. [See **RPI** Form 552 §4.5e]

As an alternative to the CPI, rent provisions may call for an annual percentage increase in rent over the base rent, or simply state an increased dollar amount for rent in each year of the lease term. This type of annual rent adjustment is called *graduated rent*. [See **RPI** Form 552 §4.4]

The lease agreement rent provisions need to precisely state any rent adjustment formulas to be enforced by the landlord. [See Sidebar, "Rent provisions and the NOI"]

Setting the grace period and late charge

The rent provisions in a commercial lease agreement include the:

- dollar amount of the rent;
- time for payment;
- place for payment; and
- manner of payment.[1]

1 **Levin** v. **Saroff** (1921) 54 CA 285

Sidebar

Rent provisions and the NOI

*The rent payments a landlord actually receives from all tenants constitutes the landlord's effective rental income from the property for the period analyzed. [See **RPI** Form 352 §2.2]*

The current rent and the terms for setting future rents as called for in the rent provisions of the lease agreement greatly influence the:

- ***market value of the real estate;***
- ***amount of long-term financing available;***
- ***property's attractiveness to potential buyers; and***
- ***landlord's future return on their investment.***

The calculation for setting the market value of a commercial income property is based primarily on its anticipated future net operating income (NOI). A property's NOI is composed of the property's gross operating income less operating expenses. Without a future flow of NOI, improved real estate has little value greater than the value of the land. Unless rental income exists to be capitalized, the property's value cannot be properly established.

Brokers and investors rely on the present and anticipated future NOI of a property to arrive at its current fair market value.

The NOI is initially capitalized at the current yield obtainable on comparable investments. The capitalization rate sets the property's fair market value for the price (present worth) a buyer will likely pay, and the amounts a lender will likely lend, based on the property's fundamentals.

Lenders limit mortgage amounts secured by real property based on:

- ***the property's NOI; and***
- ***the financial strength of the tenants to meet their lease obligations.***

Likewise, buyers determine what purchase price they will set in an offer based on (among other things):

- ***the property's NOI;***
- ***a review of the tenants' financial track records; and***
- ***the landlord's control over operating costs.***

Thus, the leasing agent or property manager negotiating a commercial lease for a landlord ensure that lease agreements produce rents and control costs effectively to produce a maximum return, now and in the future.

Additionally, if the landlord is to receive prepaid rent, the lease agreement needs to include a provision stating the tenant will pay rent in advance.[2] [See **RPI** Form 552 §4.1]

Rent payments not timely received by the landlord are considered **delinquent**. Rent is not delinquent until any **grace period** expires. In commercial (and residential) lease agreements, the grace period is negotiable by the landlord and the tenant. There are no legal mandates on the length of a *grace period,* or that a grace period even be granted. [See **RPI** Form 552 §4.7]

Having established a grace period by agreement or conduct, the landlord may not serve a three-day notice to pay until the grace period expires.

2 CC §1947

The landlord may contract for a late charge as reimbursement for their delinquent rent collection efforts. The charge needs to be reasonably related to the landlord's out-of-pocket costs incurred during collection efforts or the delay in receipt of the untimely payment.

Late charges are typically assessed in leases as either a percentage of the rent due or a flat rate charge. The flat rate charge is to approximate the costs incurred to enforce collection and the loss of use of the rent money. In addition to dollar amounts equivalent to reimbursement of collection costs, the accrual of interest on any delinquent amount is often included to cover loss of the use of rent monies. [See **RPI** Form 552 §4.8]

Place and manner of payment

Rent is to be paid in U.S. dollars at a set location, such as at the landlord's or leasing agent's office. The rent may be delivered personally or by mail. [See **RPI** Form 552 §4.6a]

However, rent does not have to be paid with money. Rent may be paid by the delivery of crops, precious metals, services, assets or other currencies.[3]

The manner of rent payment is also established. Typically, landlords will accept cash, check, credit card, electronic transfer or other means of transmitting funds.

A landlord may charge a flat rate for a check returned for insufficient funds. However, the charge must be memorialized in the lease agreement in order for the landlord to shift this expense item to the tenant. [See **RPI** Form 552 §4.9]

If the tenant's check is returned for insufficient funds, the landlord may require payment of rent in cash or by money order. However, this cash requirement may not apply to rents after a three month period. After three months, the landlord is required to again accept alternate forms of payment.[4] [See **RPI** Form 552 §4.9]

When square footage sets the rent

In commercial leases for industrial, commercial, office and retail space, the base rent is generally set as a dollar amount, determined by multiplying the total number of square feet rented by a per-square-foot rate.

For example, a tenant leases 4,000 square feet at $2 per square foot. The base rent is set for the lease as $8,000, payable monthly.

The per-square-foot rent formula is used to negotiate the lease, and then a specific dollar amount of rent is stated in the lease agreement. The per-square-foot formula used in negotiations usually is not mentioned in the lease agreement unless the footage is uncertain at the time the lease is entered into.

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3 **Clarke** v. **Cobb** (1898) 121 C 595

4 CC §1947.3

When the base rent or any additional rent, such as **common area maintenance charges (CAMs)**, is based on square footage stated in the lease, the space attributable to the leased premises is to be clearly defined and accurately measured.

To avoid disputes, the landlord and tenant agree on how the square footage will be measured:

- from the interior walls;
- from the middle of common walls;
- from the exterior of the walls; or
- to include a portion of the common hallways, lobby, restrooms or other interior areas of the structure.

The standard for determining how the square footage will be measured is negotiated through the offers and counteroffers to lease, and the competitive availability of space.

Additional rent and other sums due

As additional rent, the commercial tenant may pay some or all of the costs of operating the property, producing various modifications of a gross or net lease agreement. Operating costs include:

- expenses incurred in the ownership and operations of the property; and
- future increases in these expenses. [See **RPI** Form 552-3]

CAM provisions obligate the tenant to pay a pro rata share of the costs incurred by the landlord to maintain the common areas of the property and otherwise defray the costs of ownership, which may include:

- utilities (water, electric, etc.);
- heating, ventilation and air conditioning (HVAC);
- sewage;
- garbage;
- janitorial services;
- landscaping;
- security;
- insurance premiums;
- management fees; and
- property taxes and assessments. [See Figure 1, Form 552]

CAMs are classified as additional rent and generally arise in multi-tenant projects. Customarily, CAMs owed by a tenant are based on the ratio between the space leased by the tenant and the total rentable space in the project.

The term *"common area"* is broadly defined to include sidewalks, corridors, plazas, halls, restrooms, parking facilities, grounds, etc.

Figure 1

Excerpt from Form 552

Commercial Lease Agreement

Gross — Single Tenant

5. OPERATING EXPENSES:

5.1 Tenant is responsible for payment of utility and service charges as follows: ______________________________.

5.2 Landlord is responsible for payment of utility and service charges as follows: ______________________________.

5.3 Tenant will, on request of Landlord, authorize their utility companies to release energy consumption data directly to Landlord for Landlord's Data Verification Checklist used for energy benchmarking purposes and, upon further request, provide energy consumption data on the Premises. [See **RPI** From 552-9]

5.4 Tenant to pay all taxes levied on trade fixtures or other improvements Tenant installs on the Premises.

5.5 If Landlord pays any charge owed by Tenant, Tenant will pay, within 30 days of written demand, the charge as additional rent.

5.6 Landlord to pay all real property taxes and assessments levied by governments, for whatever cause, against the land, trees, tenant improvements and buildings within the Project containing the Premises, excluding those to be paid by Tenant under Section 5.4.

6. REPAIR AND MAINTENANCE:

6.1 The Premises are in good condition, ☐ except as noted in an addendum. [See **RPI** Form 250]

6.2 Tenant will keep the Premises and its improvements in good order, condition and repair, including all fixtures related to plumbing, HVAC components, electrical, lighting, and ☐ ______________________________.

a. ☐ See attached maintenance modification addendum. [See **RPI** Form 552-6]

6.3 Except as stated in Section 6.2, Landlord will maintain in good order, condition and repair the structures and common area components and equipment within the Premises which exist on the commencement of this lease agreement, including but not limited to existing HVAC, plumbing and sewers, electrical systems, structural foundations, exterior walls, store front, plate glass in exterior walls, roof, government-mandated retrofitting, parking areas, lawns and shrubbery, sidewalks, driveways/right of ways, and ☐ ______________________________.

The term "maintenance" is defined to include garbage removal, janitorial services, gardening and landscaping, repairs and upkeep, utilities and other specified operating costs.

The allocation of responsibility for operating expenses depends on:

- the type of property and its use;
- the relative bargaining positions of the landlord and tenant in the current real estate market;
- the financial objectives of the landlord and tenant; and
- the length of the lease term.

The landlord and tenant may agree the property operating expenses will be paid by the tenant directly to the provider or creditor, or indirectly to the landlord as a CAMs reimbursement.

Taxes and assessments

Tenants with long-term leases often agree to pay some or all of the real estate taxes, insurance premiums and special assessments when the leased premises is an industrial or other free-standing, single-use building.

Simply put, the annual cost to a tenant is basically the same whether the landlord receives rent (a greater amount) and pays operating expenses out of the rent, or the tenant pays rent (a lesser amount) plus operating costs. Expenses are always eventually paid by the tenant, whether paid directly or indirectly through the landlord. If the tenant directly pays operating expenses or reimburses the landlord via CAMs, then the tenant, not the landlord, carries the risk they will increase.

Property is reassessed by the county assessor when the landlord sells their interest, even if the tenant remains in possession.[5]

5 Calif. Revenue and Taxation Code §60

If the landlord sells the leased property and the property is reassessed at a higher valuation, the increase is attributed to the landlord, not the tenant. [See **RPI** Form 552 §4.5]

A savvy tenant will demand a cap on any rent increases due to reassessments caused by the landlord. When a cap is agreed to in the lease, the landlord is responsible for any property tax increases exceeding the cap. However, the tenant is held responsible for the payment of assessments and taxes caused by their own improvements and trade fixtures. [See **RPI** Form 552 §4.3]

Utility charges

The *utilities provision* covers the cost of utilities used in the space leased by the tenant. They are separate and distinct from the utilities required to operate the common areas. [See Figure 1, Form 552 §§5.1, 5.2]

To protect against the increased cost of utilities consumed by the tenant, the landlord who pays for utilities may negotiate to pass the responsibility on to the tenant. The landlord may determine the tenant's pro rata share, or have each leased premises privately metered to determine the charge for the tenant's consumption.

Tenants who use a lot of energy or utilities should be required to contract with the utility companies themselves.

As a practical matter, the landlord avoids paying the utilities whenever possible, except, perhaps, for water. However, if the landlord pays the utilities and charges the tenant, the charge is additional rent to all other rent agreed to be paid.

Chapter 22 Summary

Various rent formulas exist to meet the demands of the marketplace and the financial needs of the landlord and tenant.

A lease agreement which sets monthly rent payments at a specific dollar amount over the entire life of the lease is called a fixed-rent lease. A lease agreement with a rent provision that calculates the total amount of rent the tenant will pay as a percentage of the tenant's gross sales is called a percentage lease.

Many commercial lease agreements contain provisions under which the base rent is adjusted periodically. Common price adjustment provisions include:

- an inflation-adjusted rent provision, which adjusts for annual price inflation as measured by the Consumer Price Index (CPI);
- a graduated rent provision which increases rent from year to year in set percentage or dollar amounts; and
- the appreciation-adjusted rent provision, which adjusts for property price appreciation every five years or so due to changes in local market conditions.

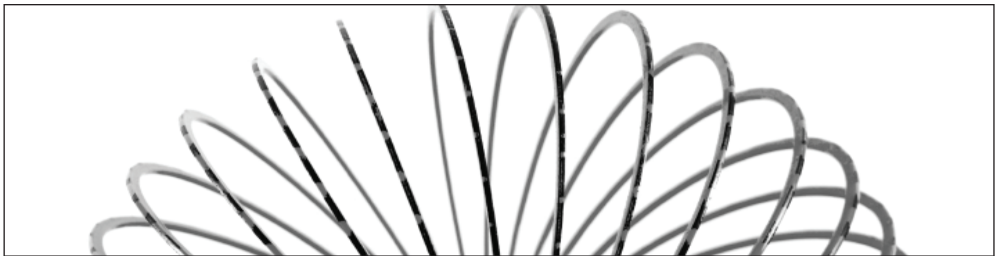
In a rising local economy or period of general price inflation, a long-term fixed-rent lease will prove to be a financial disaster for the landlord. However, a landlord may be forced to accept fixed-rent leases over a short period of time due to economic downturns or static rental markets.

When leasing space in larger, multi-tenant retail properties, landlords often negotiate a rent provision that calculates the total amount of rent the tenant will pay as a percentage of the tenant's gross sales. Tenants with long-term leases often agree to pay some or all of the property taxes, insurance premiums and special assessments when the leased premises is an industrial or single-use building.

The rent provisions in a commercial lease agreement include the:

- dollar amount of the rent;
- time for payment;
- place for payment; and
- manner of payment.

Chapter 22 Key Terms



Chapter 23

Adjustable rent provisions

Learning Objectives

After reading this chapter, you will be able to:

- structure rent and expense provisions in commercial lease agreements to protect a landlord's capital investment;
- use a graduated rent provision on a short-term commercial lease to increase the monthly rent due based on either a specific dollar amount or percentage of the base year rent;
- protect the property's income by including an inflation-adjusted rent provision in the lease agreement to keep the property's annual rental income increasing to match the annual rate of inflation; and
- use a percentage lease to have additional rent calculated as a percent of the tenant's gross sales year be paid separately from the base rent due monthly.

Key Terms

appreciation-adjusted rent provision

base rent

graduated rent provision

inflation-adjusted rent provision

Economic goals of commercial landlords

Rent earned from leased space generates a yield on the landlord's investment in the real estate. Conceptually, rent is economically similar to a lender's receipt of interest for the use of money loaned.

At the end of their right-to-use periods, the real estate and the money are returned to the landlord and the lender, respectively.

Like interest rate provisions in a note, **rent provisions** in a commercial lease agreement are structured to anticipate future market changes that will affect the investment (value, income, expenses and debt). Even creditworthiness standards applied to both are the same, based on income.

Figure 1

Excerpt from Form 552

Commercial Lease Agreement

Gross — Single Tenant

4.4 **GRADUATED RENT:** ☐ Monthly rent, from year to year, is graduated on anniversary months as follows:
Initial year's monthly rent to be $______________, and continues until:
a. ☐ _____% increase in monthly rent over prior year's monthly rent for years ____________ to _______,
_____% increase in monthly rent over prior year's monthly rent for years ____________ to _______,
_____% increase in monthly rent over prior year's monthly rent for years ____________ to _______,
b. ☐ Monthly rent commencing on the _______ anniversary to be . . . . $____________,
Monthly rent commencing on the _______ anniversary to be . . . . $____________,

As discussed in the previous chapter, *fixed-rent leases* do not anticipate future changes in the investment's fundamentals. However, variable or adjustable-rent leases do anticipate negative market changes. Properly structured, variable- or adjustable-rent leases shift increased costs and positive demographic influences to the tenant by way of an equal increase in rent.

Landlords have a financial need to protect the growth and value of their capital investment in commercial income property. The sole method a landlord has for maintaining the value of income property from year to year is through rent and expense provisions in lease agreements.

To accomplish this feat, the landlord's leasing agent anticipates the type of rent and use-maintenance provisions for a lease agreement that will deliver the maximum **net operating income** throughout the life of the lease. Applying the care and protection owed the landlord in negotiations, the agent will provide the landlord with future benefits of rents that stay in line with inflation and demographic-driven appreciation.

Since net income from operations sets value and pricing, attention to any ability to shift future cost increases to the tenant will further enhance future value. Future capitalization rates following 2014 will play a role, driving values inversely to the inevitably rise in rates.

Types of adjustable rent

graduated rent provision
A rent provision in a commercial lease agreement which increases the initial monthly rent in pre-set increments over the term of the lease. [See **RPI** Form 552 §4.4]

The three basic types of commercial *rent adjustment provisions* (also known as **rent escalation clauses**) are:

- **graduated rent provisions** [See Figure 1];
- **inflation-adjusted rent provisions** paired with **appreciation-adjusted rent provisions** [See Figure 2 and Figure 3]; and
- **percentage lease rent provisions.** [See Figure 4]

The economic goals a leasing agent reviews with their commercial landlord-client when negotiating provisions for future rents include:

- adjustments for lost purchasing power due to future consumer price inflation;
- adjustments in rent to reflect the rate of appreciation on comparable properties (beyond the rate of inflation), a demographics issue; and
- the absorption or pass-through of increased operating expenses or interest adjustments on mortgage debt.

4.5 **CPI ADJUSTED RENT:** ☐ Monthly base rent for the initial 12 months of the term is the amount of $______________, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable Consumer Price Index for All Urban Consumers (CPI-U) figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.

a. The applicable CPI-U (1982-1984 = 100) is:
☐ Los Angeles-Riverside-Orange County, ☐ San Francisco-Oakland-San Jose
☐ San Diego, ☐ National, ☐ ______________________________________.

b. Annual rent increases under CPI-U adjustments are limited to an increase of ______%.

c. On any anniversary adjustment, if the CPI-U has decreased below the CPI-U for the prior 12-month period, the monthly rent for the ensuing 12 months will remain the same as the rent during the prior 12 months.

d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index will be used to compute annual adjustments

Figure 2

Excerpt from Form 552

Commercial Lease Agreement

Gross — Single Tenant

To protect the property's income (and its value) due to inflation, rent is adjusted periodically by including an *inflation-adjusted rent provision* in the lease agreement. An inflation clause calls for annual rent increases based on figures from an inflation index, such as the **Consumer Price Index (CPI)** or the **Cost of Funds Index**. [See Figure 2]

Rent may also be adjusted to reflect an increase in the property's dollar value brought about by local appreciation. This is accomplished in long-term leases by including an *appreciation-adjusted rent provision* in the lease agreement calling for the adjustment to be made every few years, commonly five. [See Figure 3]

Also, a landlord passes on increased operating and ownership costs to the commercial tenant by shifting responsibility for payment to the tenant for:

- all or some of the operating expenses;
- future increases in operating expenses; and/or
- a pro rata share of CAMs, property taxes and hazard insurance premiums.

Future increases in the cost of carrying debt on the property due to variable interest rate mortgage financing is passed on to the tenant as increased rent to provide the landlord with a *net lease* arrangement.

A landlord with knowledge and understanding about the economic and financial consequences of proposed lease terms makes a more informed financial decision whether to accept, counter or reject the tenant's offer to lease. The level of negotiations is no better than the level of leasing knowledge held by the landlord and their leasing agent.

Graduated rents from year to year

The most common rent adjustment provision used in short-term commercial lease agreements is the *graduated rent provision*. [See Figure 1]

base rent
The minimum monthly rent due under a commercial lease agreement. [See **RPI** Form 552 §4.3]

Graduated rent provisions increase the monthly rent due in the years following the first year's payment of a **base rent**. The adjustments are made annually, or sometimes semi-annually. The periodic upward adjustment is either:

- a specific dollar amount as the rent due; or
- a percentage of the base year rent or rent paid during the previous period. [See Figure 1]

When setting the rent adjustment amount, be it a dollar or percentage figure, the landlord takes into account:

- expected rate of future inflation, say 2% as now anticipated by wisdom of the long-term bond market;
- local market conditions, such as expected user demand and scarcity of like properties, demographics of increased density and incomes, traffic counts and infrastructure improvements contributing to property appreciation; and
- the tenant's evolving use and its burden on the property and improvements.

Rather than being tied to a formal index, the rent increases set by a graduated rent provision are negotiated. No paradigm exists, but increases of, say, 3% are customary in some markets, as it provides returns to the landlord exceeding inflation.

Recession and recovery

During recessionary times and recovery stages in a business cycle, graduated rent provisions are popular when the landlord seeks to incentivize tenants to lease vacant space. The landlord agrees to a low initial *teaser rent*, in addition to a few months of rent-free possession to offset the tenant's initial set up or relocation costs. The graduated rent provision then bumps up the rent so any below-market rents paid in the early years are picked up in future rents that may even exceed market rates. This is similar to the negative amortization feature in Millennium Boom *adjustable rate mortgages (ARMs)*.

Any up-front, rent-free period needs to be viewed as part of a vacancy and lost rents factor since no rent is received to contribute to gross income. The cost of any *tenant improvements (TIs)* the landlord pays is recovered by totaling:

- the monthly amount of an amortized payment of the costs of the TIs over the initial term of the lease; and
- the amount of monthly rent the property commands before TIs.

Inflation-adjusted rent provisions

Inflation-adjusted rent provisions keep the property's annual rental income increasing to match the annual rate of consumer price inflation. An inflation provision calls for annual upward rent adjustments based on figures from an inflation index, such as the *CPI* or the *Cost of Funds Index*. [See Figure 2]

The CPI is an index of fluctuations in the dollar price the local population pays for consumable goods and services. Use of the CPI to adjust rents

Case in point

Setting fair market rents

Consider a commercial lease agreement with a use provision calling for the tenant to operate a movie theater on the premises for ten years.

The lease agreement contains a rent appreciation clause stating the landlord will adjust the base rent in five years to reflect the then-current fair market rent.

At the time for the appreciation adjustment five years later, the landlord determines the fair market rent for the property by using rent amounts received by comparable properties put to higher and better uses than a movie theater.

The tenant disputes the amount of the adjusted rent demanded by the landlord.

The tenant claims the fair market rental value of the premises is based on the present use of the property as intended by the lease. The tenant argues that the lease agreement does not provide for the landlord to adjust the rent to reflect a return on the fair market value of properties that have been put to a higher and better use.

*Here, the lease agreement states the tenant will use the property to operate a movie theater for the term of the lease. The rent may only be adjusted to reflect the fair market value of the property based on its use as a movie theater. [**Wu** v. **Interstate Consolidated Industries** (1991) 226 CA3d 1511]*

recovers the dollar's annual loss of purchasing power to pay for goods and services. Occupancy of property is a service consumed by the public using dollars to pay rent.

inflation-adjusted rent provision
A rent provision in a commercial lease which calls for periodic rent increases based on changes in inflation index figures during the period. [See **RPI** Form 552 §4.5]

The CPI-U is the value for urban consumers, and is the benchmark used to adjust rents for inflation. For simplicity, we'll refer to CPI-U as just the CPI. The CPI is a widely recognized index, easily understood and inexpensive to administer.

Implementing the CPI method

Here are some basic guidelines to follow when using the CPI method:

- set a base rent payable monthly during the first year of the lease, also called the **minimum rent** (floor);
- indicate the exact index to be used for the CPI adjustment figures (e.g., the Los Angeles-Riverside-Anaheim CPI);
- indicate an alternative index if the one selected is discarded or altered;
- note the month for the CPI figure to be used to compute annual adjustments (the third month prior to commencement); and
- state the month payments begin at the adjusted amount (e.g., anniversary month for the commencement of possession under the lease agreement).

A good practice is to use CPI figures for the third month preceding commencement of the lease to compute periodic adjustments. But why not use the CPI for the month in which rent is adjusted?

When the CPI figure hasn't been released, which will be the case when using the figure for the month of commencement, the landlord needs to

Figure 3

Excerpt from Form 552

Commercial Lease Agreement

Gross — Single Tenant

e. Following each _____-year period after commencement, including any extensions and renewals, the monthly rent is to be adjusted upward to current market rental rates for comparable premises. Computation of any future annual CPI-U adjustments in monthly rent on each anniversary month after adjustment to current market rental rates will treat the monthly rent for the initial 12 months of each market rent adjustment as the initial monthly base rent, and treat the first month of each market rent adjustment as the month of commencement for selecting the Index figures. Landlord to reasonably determine and advise Tenant of the adjusted rental rates no less than 3 months prior to the effective date of the adjustment.

estimate the rent due for the anniversary month. When the CPI figure for the anniversary month is later released and the rent adjustment is calculated, the landlord then needs to account for the rent received beginning with the anniversary month. Using a CPI figure for the third month prior to the adjustment guarantees an actual figure is available with plenty of time to calculate the rent adjustment and advise the tenant of the adjusted rent amount.

Calculating the CPI: Year-to-year CPI adjustment

Under annual rent inflation adjustment provisions, the prior year's rent and CPI are used to set the adjusted rent. [See Figure 2]

Thus, the year-to-year adjustment formula is:

$$(\textit{current CPI} \div \textit{last year's CPI}) \times \textit{current rent}$$

Though widely used, CPI only addresses inflation resulting from the Federal Reserve's (the Fed's) **monetary policy**. CPI is limited to measuring changes in the purchasing power of the dollar as reflected in the prices of consumer goods and services, which include rents. The CPI does not reflect changes in the property's actual rental value, only in the amount of rent. Thus, to capture both inflation and long-term appreciation in rents, inflation-adjusted rent provisions are often paired with appreciation-adjusted rent provisions.

Appreciation-adjusted rent provisions: local demographics

Rents are also forged by public *appreciation* for a property's location, the result of a combination of:

- local demographics (density and income sets the level of demand for space);
- government investments and programs in the community; and
- supply of available units or space in the local market. [See Figure 3]

Long-term commercial lease agreements need rent provisions which capture the financial benefits these conditions create for property owners (and tenant businesses) over time. To garner the value of evolving local economic conditions, appreciation-adjusted rent provisions are included in the commercial lease agreement. Through the provision, rents are adjusted every three to five years to capture any increase in rents brought about by the effect of local appreciation, increasing rents beyond the inflation-adjusted increase in rent.

4.4 **ADDITIONAL PERCENTAGE RENT:** Additional percentage rent equal to ______% of gross sales income made from the Premises during each calendar year, less credit for base rent, real estate taxes, insurance, assessments and common area maintenance (CAM) charges paid by Tenant for the calendar year, is to be paid as described below:

a. The percentage rent due for each month of the lease will be paid and delivered with a signed written statement of the gross sales income and percentage computation by the tenth day of the following month.

b. The additional percentage rent computed for each month to be credited for base rent, taxes, insurance, assessments and CAMs paid by Tenant for the month.

c. Within one month after each calendar year and on expiration of the lease, Tenant to compute and deliver a written statement of the year's sales and the additional percentage rent calculated for the calendar year, less credit for base rent, taxes, insurance and CAMs paid for the calendar year, to annually determine the percentage rent remaining due from Tenant or to be refunded to Tenant by Landlord, which difference will be paid on delivery of the annual statement.

d. Gross sales income includes all money or equivalent received by Tenant, subtenant, licensees or concessionaires, in the ordinary course of business, whether wholesale or retail, cash or credit, less credit for goods returned by customers.

e. Landlord has the right, on reasonable notice, to audit Tenant's books regarding sales information.

Figure 4

Excerpt from Form 552-4

Commercial Lease Agreement — Percentage Lease

The longer the lease term, the more likely an appreciation-adjusted rent provision will be negotiated and included in the lease agreement. [See **RPI** Form 552 §4.5e]

appreciation-adjusted rent provision
A rent provision found in a commercial lease agreement which adjusts rent every several years to reflect an increase in the rental value of a property exceeding the rate of inflation brought about by local demographics. [See **RPI** Form 552 §4.5e]

The amount of rent increase due to appreciation is determined by a rental market analysis of comparable properties at the time of the rent adjustment. This includes situations unique to the leased property, such as:

- new developments or increased business activity at the location of the property;
- demand for like properties in the immediate area; and
- traffic counts and patterns directly affecting the property, often determined by the location of big anchor tenants.

Again, appreciation-adjusted rent provisions work in tandem with the inflation-adjusted rent provisions. The inflation adjustment is annual; the appreciation adjustment takes place every three to five years.

Percentage lease rent provisions for high traffic sites

The percentage lease rent provision works a little differently from other rent adjustment provisions. While using different formulas for adjusting rent, rent provisions have one common feature – the *base rent*. The base rent is the minimum rent paid by the tenant to the landlord each month.

Percentage lease rent provisions have a formula for additional rent to be paid separately from the monthly base rent due, called **percentage rent** or **overage rent.** *Percentage rent* due is typically calculated as a percent of the tenant's gross sales less the amount of base rent paid monthly during the year, a natural breakpoint arrangement. Percentage lease rent provisions are commonly negotiated with restaurants and retail tenants dependent on high vehicular or foot traffic to drive their sales. [See Figure 4]

Pairing the base rent amount with a percentage rent formula assures the landlord a full return at the appreciated rental value for the property due to its location. Thus:

- the base rent provides the landlord with a minimum return on investment for the tenant's use of the property; and

- the additional percentage rent provides the landlord with a return on their investment based on the contribution of the property's location to the tenant's operating success.

The additional rent is triggered when the tenant's gross income from sales exceed a negotiated dollar threshold, known as the **breakpoint.** The *natural breakpoint* is the point at which the calculated percentage rent amount for a period, say one year, exceeds the base rent paid during the period. However, landlords and tenants may negotiate a higher or lower breakpoint for the additional rent to kick in than the amount of base rent paid. A lower breakpoint increases the rent the landlord receives.

Formulating and negotiating additional rent under a percentage lease

To determine the formula for additional rent under a percentage lease rent provision, the landlord relies on an estimate of the tenant's gross sales for the first 12 months of operations, as well as:

- the traffic count and traffic patterns at the location of the premises;
- the dollar amount of anticipated sales and average dollar sales; and
- the price range of the goods and services to be offered.

The landlord then negotiates with the tenant to set the percentage of the tenant's annual gross sales for calculating the additional rent. With a natural breakpoint, when the percentage amount exceeds the base rent paid, the tenant pays the excess amount as additional rent.

Percentage rent is typically due within a month or two after the end of the year, when the tenant's gross income for the period is known. The frequency of the additional rent payment is negotiable, based on:

- whether the tenant's sales trends are constant or seasonal; and
- the financial strength of the tenant.

Calculating percentage rent

Consider a landlord and tenant who agree to a base rent of $5,000 per month, or $60,000 per year. The percentage rent provision calls for the payment of rent equal to 6% of the tenant's gross income, paid monthly at the base rent amount with the balance due annually. The landlord and tenant agree to a natural breakpoint.

At the end of the year, the tenant has a gross income of $1,500,000. The total percentage rent due is $90,000 ($1,500,000 x 0.06). The percentage rent exceeds the annual base rent by $30,000. Thus, the total rent owed to the landlord for the year is:

- $60,000 in base rent, paid monthly during the year; and
- $30,000 in excess percentage rent, paid within 30 to 60 days after the end of the year.

Chapter 23 Summary

Landlords have a financial need to protect the growth and value of their capital investment in commercial income property. The sole method for maintaining the value of income property from year to year is through rent and expense provisions in lease agreements.

The three basic types of commercial rent adjustment provisions are:

- graduated rent provisions;
- inflation-adjusted rent provisions paired with appreciation-adjusted rent provisions; and
- percentage lease rent provisions.

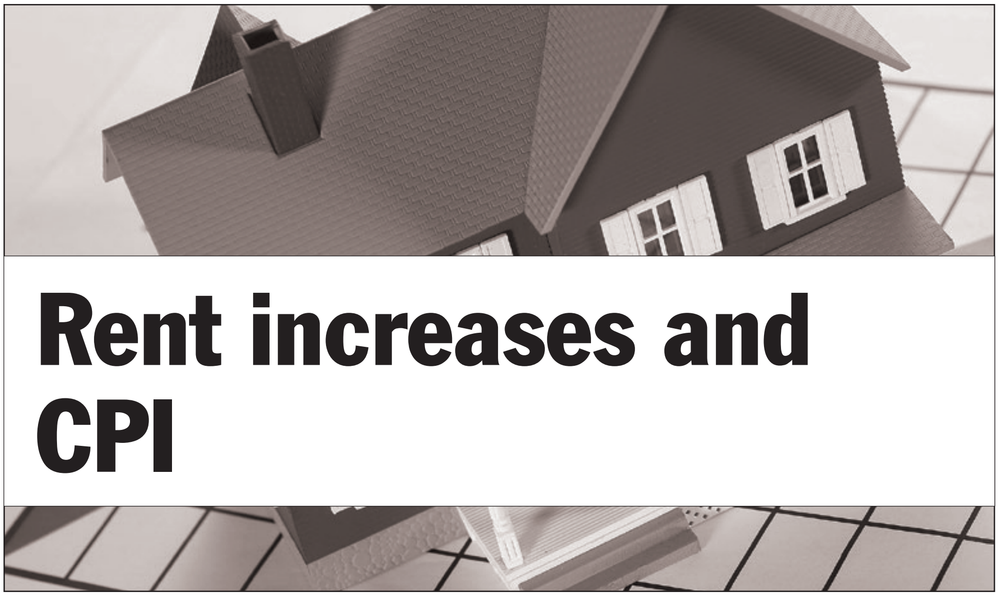
The most common rent adjustment provision used in short-term commercial lease agreements is the graduated rent provision. Graduated rent provisions increase the monthly rent due in the years following the first year's payment of a base rent. The periodic upward adjustment is either a specific dollar amount or a percentage of the base year rent or rent paid during the previous period.

To protect the property's income due to inflation, rent is adjusted periodically by including an inflation-adjusted rent provision in the lease agreement. An inflation clause calls for annual rent increases based on figures from an inflation index, such as the Consumer Price Index (CPI) or the Cost of Funds Index.

Rent may also be adjusted to reflect an increase in the property's dollar value brought about by local appreciation. This is accomplished by including an appreciation-adjusted rent provision in the lease agreement.

Alternatively, percentage lease rent provisions have a formula for additional rent to be paid separately from the base rent due monthly, called percentage rent. Percentage rent due is typically calculated as a percent of the tenant's gross sales less the amount of base rent paid monthly during the year. Percentage lease rent provisions are commonly negotiated with restaurants and retail tenants dependent on high vehicular or foot traffic to drive their sales.

Chapter 23 Key Terms



Chapter 24

Rent increases and CPI

Learning Objectives

After reading this chapter, you will be able to:

- understand the interrelationship between rents, inflation and appreciation;
- distinguish the effect of inflation from appreciation in any increase in a property's rents; and
- provide for a shift of rent inflation and appreciation to the tenant in lease agreement rent provisions.

Key Terms

appreciation-adjusted rent provision

Consumer Price Index (CPI)

inflation

Coping with inflation through rent

A long-term investment goal of an owner of rental property is to generate future **annual net operating income** sufficient to keep the property's value rising in line with consumer inflation.

An income property owner's primary goal is to negotiate the best possible rental rate consistent with the highest occupancy rate attainable when entering into a lease agreement. Part of this income goal is to bargain for periodic upward rent adjustments over the life of the lease. Rent adjustments are needed to cover the loss of purchasing power in the initial rent amount brought on by annual consumer price inflation.

For example, rent adjustments may be set to match the annual price inflation experienced in the region. Thus coupled with inflation, rental income will increase from year to year to maintain the original purchasing power of the property's initial rental income over the life of the lease.

Consumer Price Index (CPI)
The CPI measures and tracks the rate of consumer inflation. This is presented as an index of fluctuations in the general price of a wide selection of consumable products – goods and services.

appreciation-adjusted rent provision
A rent provision found in a commercial lease agreement which adjusts rent every several years to reflect an increase in the rental value of a property exceeding the rate of inflation brought about by local demographics. [See **RPI** Form 552 §4.5e]

inflation
The price change in consumer goods and services, stated in the consumer price index (CPI) as a figure which is reported as a percentage change over one year ago.

For decades prior to the mid-1970s, rent adjustments in an environment of slowly rising interest rates were of little concern as inflation and appreciation rates remained low. The 1980s saw marked increases in rents and operating costs to reflect the excessive inflation of the 1970s.

By the early 1990s, rents declined and appreciation rates in California reversed, stabilizing during the late-1990s. After the turn of the century, rents again began to increase, exceeding the rate of inflation as reflected in the **Consumer Price Index (CPI)**. By 2007, rent increases began to stabilize in all areas and on all types of properties, as the real estate boom years of the mid-2000s came to a halt.

Unlike rent **appreciation** experienced by a property due to enhanced local demographics, rent **inflation** is limited by any decline in the quantity of a consumer item a dollar will buy due to a general price increase for the same item. In this case, the item is the square footage of space which can be purchased at a certain amount of rent.

Inattentive landlords and agents occasionally fail to anticipate trends in *inflation*. They saddle themselves with long-term lease agreements containing rent provisions which do not adjust rent for inflation or *appreciation*. Since future rents are formulated in lease agreement rent provisions, the worth and equity of the property can be calculated at any time during the term of the lease based on the capitalization rate then applied by investors. [See **RPI** Form 552 §4.5]

Unless rent is periodically increased over the life of a long-term lease or a lease with renewal options, lease provisions setting future rents may be economically disastrous for the landlord. The periodic upward adjustments in rent amounts to be considered include:

- the rate of consumer price inflation; and
- local demographic price appreciation.

A number of methods exist to keep pace over the term of a lease with consumer inflation, property rent appreciation and increases in the landlord's operating and ownership expenses beyond the rate of inflation.

CPI covers price inflation

The best method for coping with the uncertainty of future inflation is to tie the amount due as future rents to figures published in the federal government's *CPI*. The monetary policy for the dollar is set by the Federal Reserve (Fed) at 2% annually. However, inflation of greater amounts may be engineered by the Fed for a short period of time to offset declines in government spending. This Fed action boosts consumer spending, which in turn creates more jobs, raising employment to the level sought by the Fed.

Commercial lease agreements usually set a base monthly rent which is constant for the first year. For the following years, annual rent is adjusted by factoring in the annual change in local or regional CPI figures. [See Figure 1]

For residential rent increases, most rent control communities use a form of the CPI to allow for the amount of automatic annual rent adjustments permitted by ordinance. The rent control formulas have worked well for landlords, especially when rents slip for reason of increased supply (construction and SFR conversion to rentals) or reduced demand (job loss during a recession).

Residential leases only infrequently exceed one year. Thus, most residential lease agreements do not need to address an adjustment in monthly rents to compensate for inflation. Rent increases are negotiated at the end of the leasing period and set based on comparable market rates or, in noncompetitive environments due to restrictive zoning, as dictated by rent control.

CPI and its regions

CPI figures are published monthly, bi-monthly or semi-annually by the U.S. Bureau of Labor Statistics for numerous metropolitan areas across the states. The CPI is the most widely used indicator of inflation.

The CPI measures the overall price change from month to month, positive or negative, for a "basket" of consumer goods and services people are believed to buy or consume. The CPI-U is based on the price of food, clothing, shelter, fuel, transportation fares, routine medical charges, drugs and other goods bought for day-to-day living.

Real estate lease agreements with provisions for annual adjustments based on the **rate of inflation** most commonly use inflation figures from the regional CPI-U, the CPI for the area's urban consumers. A regional CPI-U covers the buying habits of approximately 80% of the population within the designated area. [See Figure 1]

The three CPI regions within California are:

- Los Angeles-Anaheim-Riverside (issued monthly);
- San Francisco-Oakland-San Jose (issued bi-monthly); and
- San Diego (issued semi-annually).

If property does not fall within or near one of the regions, a landlord may also use the CPI-U for a larger geographical area such as:

- the West Region CPI-U; or
- the U.S. City Average CPI-U.

Issuance date for the CPI figure

The San Francisco-Oakland-San Jose CPI-U is issued bi-monthly covering consumer expenditures for two months — the month of issuance and the preceding month. The bi-monthly CPI-U for the San Francisco area is issued on even-numbered months such as February, April, June, etc.

Thus, the landlord with an adjustment index tied to the January CPI-U for the San Francisco-Oakland-San Jose area uses the CPI-U which comes out in February.

However, the landlord located in the San Francisco-Oakland-San Jose or San Diego areas may wish to switch to a larger geographical area CPI-U index which is issued on a monthly basis. For example, the landlord may consider using the West Region CPI-U.

If the landlord seeks to switch to a different index after entering into the lease agreement, the landlord and tenant needs to agree to the use of the new index.

Inflationary cycles and the CPI

A few basic principles of real estate economics need to be considered when applying CPI figures to periodically adjust rent upward. A rent adjustment based on consumer price inflation covers the negative effect inflation has on the purchasing power of the landlord's rental income. With each inflation adjustment made in rent by the landlord, the commercial tenant in turn passes on the rent increase to consumers when pricing the goods and services they produce and sell.

Also, real estate rents on the reletting of comparable properties sometimes increase in excess of consumer inflation. Any annual increase in rents paid beyond the rate of inflation is appropriately called appreciated rents. Appreciated rents directly translate on application of a capitalization rate (to the NOI) to set the property's market value. The portion of the annual property value increase beyond the rate of inflation is the appreciated value of the property.

The appreciation of rent amounts (and thus property value) is driven by population density increase in the immediate area and increased personal income beyond the rate of inflation for local residents and companies. Thus, the location of the property is "appreciated" by more families and businesses.

How CPI works

Rent may not be increased during the term of a lease without an adjustment provision in the lease agreement. For instance, rent payments under a fixed-rent lease remain constant over the life of the lease. In contrast, rent under a month-to-month rental agreement may be increased by serving a notice of change in the terms of tenancy, limited for most residential units located in cities burdened with rent control.[1]

To increase rents annually for inflation, the lease needs to provide a formula for calculating the rent increases. [See Figure 1]

A lease provision that calls for adjustments based on the CPI-U may be worded to provide a *base-to-current year* increase or a *year-to-year* increase. The resulting rent amount is the same under either calculation. [See Figure 1]

1 Calif. Civil Code §827

CPI provision checklist

When the landlord decides to use the CPI method to raise rents, some basic guidelines are to be followed:

- *set, in advance, a base rent payable monthly during the first year of the lease which is the "minimum" rent (floor) below which the rent will never fall;*
- *indicate the exact index to be used (e.g., the Los Angeles-Riverside-Anaheim CPI-U);*
- *indicate an alternative index if the one selected is discarded or altered;*
- *note the CPI beginning month for computing annual adjustments (often the third month before the commencement month and anniversaries of the lease);*
- *state the actual date for the adjusted annual graduations (e.g., September 1); and*
- *include provisions to cover future changes in the property's appreciated value and operating costs (e.g., reappraisal, CAMs, etc.) whether the tenant has assigned or sublet the premises, or liened their leasehold interest. [See Figure 1]*

Choosing the beginning CPI month

Regardless of the method of adjustment, base-to-current year or year-to-year, the landlord will need to select a beginning CPI-U month.

The best month to select for the CPI-U figure used to compute periodic adjustments is the third month preceding commencement of the lease and each anniversary of the commencement. The CPI-U figure for the third month prior to the adjustment is readily available by the time the rent adjustment needs to be calculated, and the tenant is advised of the adjusted amount of rent due.

Otherwise, if the CPI-U figure chosen is for the month in which the rent will be adjusted, the landlord will need to estimate the CPI-U figure at the time of the adjustment. The actual CPI-U figure for the anniversary month will not be available for another two months. Computation of the annual adjusted rent is either by base year CPI-U to current year CPI-U, or by year-to-year CPI-U. [See Sidebar, "CPI provision checklist."]

Base-to-current year adjustment

Consider a lease rent provision which provides for a base-to-current year adjustment. [See Figure 1]

The lease commenced on January 1, 2014. The base rent is $5,000 per month for the first year. The rent is to be adjusted each January and the CPI-U index to be used is the Los Angeles-Anaheim-Riverside index.

The CPI-U figure for the October prior to January, the month of adjustment, is selected as the base month figure for rent adjustments. The CPI-U figure for the third month preceding commencement will be available to calculate the amount of the adjusted rent before the January rent is due. The CPI-U for October 2013 is 196.3, the base month figure.

In January 2015, the first rent adjustment takes place. The CPI-U for October 2014 is 206.9.

Figure 1

Excerpt from Form 552

Commercial Lease Agreement

Gross — Single Tenant

4.5 **CPI ADJUSTED RENT:** □ Monthly base rent for the initial 12 months of the term is the amount of $______________, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable Consumer Price Index for All Urban Consumers (CPI-U) figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.

a. The applicable CPI-U (1982-1984 = 100) is:
□ Los Angeles-Riverside-Orange County, □ San Francisco-Oakland-San Jose
□ San Diego, □ National, □ ____________________________________.

b. Annual rent increases under CPI-U adjustments are limited to an increase of ______%.

c. On any anniversary adjustment, if the CPI-U has decreased below the CPI-U for the prior 12-month period, the monthly rent for the ensuing 12 months will remain the same as the rent during the prior 12 months.

d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index will be used to compute annual adjustments

e. Following each _____-year period after commencement, including any extensions and renewals, the monthly rent is to be adjusted upward to current market rental rates for comparable premises. Computation of any future annual CPI-U adjustments in monthly rent on each anniversary month after adjustment to current market rental rates will treat the monthly rent for the initial 12 months of each market rent adjustment as the initial monthly base rent, and treat the first month of each market rent adjustment as the month of commencement for selecting the Index figures. Landlord to reasonably determine and advise Tenant of the adjusted rental rates no less than 3 months prior to the effective date of the adjustment.

To calculate the base-to-current year adjustment, the current CPI-U is divided by the base CPI-U and the quotient multiplied by the base rent: (current CPI-U ÷ base CPI-U) × base rent.

For the second year (2015) of the lease, the rent is $5,270 — (206.9 ÷ 196.3) × $5,000.

For 2016, the third year of the lease, the October 2015 CPI-U is 211.4. Thus, in January 2016, the rent adjusts to $5,385 — (211.4 ÷ 196.3) × $5,000.

Year-to-year adjustment

Under year-to-year rent adjustment provisions, the prior year's rent, not the base year's rent, is used to set the adjusted rent. The base year's CPI-U is not used to make the future adjustment.

Thus, the year-to-year adjustment formula is the current CPI-U divided by last year's CPI-U, multiplied by the current rent: (current CPI-U ÷ last year's CPI-U) × current rent.

CPI advantages

Three advantages are provided by using the CPI as a basis for rent adjustments. The first and most obvious advantage is the CPI is universally known and easily understood. Little room exists for the parties to disagree over the amount of a rent increase if it is tied to a government published index.

Second, the CPI is inexpensive to administer. It only takes a few minutes and a calculator to adjust the rents each year.

Third, the CPI is a widely published index and easy to locate and conform.

CPI limitations on yield

Despite the advantages, the CPI has its limitations. The CPI bears little to no relationship to changes in the property's actual rental value. The CPI only measures changes in the purchasing power of the dollar as reflected in consumer prices, which includes residential rents (not prices). Rents are forged by a combination of local demographics (density and income), government programs and supply of available units or space. However, commercial leasing arrangements need to be worded to capture these conditions over a longer period of time. Residential leases do not have this concern as the term is generally shorter. [See **RPI** Forms 550 and 551]

Each parcel of real estate is a unique asset. The location of a property makes the primary difference since no two locations have exactly the same desirability factors affecting value.

An individual property experiences an increase or decrease in rental value for a number of reasons other than inflation, including:

- traffic counts and access to the property;
- tenant demand and changes in the size and wealth of the surrounding population;
- operating expenses;
- mortgage interest rates and investor capitalization rates; and
- construction starts.

Further limitations of the CPI

The regional CPI as a factor for diminished purchasing power of a dollar takes none of these local economic factors into consideration (other than to the extent they are reflected in residential rents, which is just one aspect of CPI). Interest rates charged to homebuyers are indirectly included in the CPI by using implicit rent as the cost of possession. The effect of interest rates on real estate values is not included since debt is capital and real estate is a **capital asset**, the value of which is not itself consumed.

Cyclically, and in the short term, asset values run opposite to the direction interest rates move. When interest rates go down, values of real estate (and other assets) accelerate even as rents remain the same, and vice versa.

Also, the CPI does not mirror actual variations in the landlord's operating costs. An owner who does nothing to maintain their property can, in a high-demand location, enjoy rent increases due to the public's appreciation for the property's desirable location.

Astute tenants insist on an annual cap when rent increases are linked to CPI. For example, if the rise in the CPI figure is greater than 4% in any year, a 4% cap limits the increase despite a greater increase in the CPI.

The key is to analyze where inflation is headed. If inflation is expected to rise in the future, the CPI will initially benefit the landlord. Conversely, when inflation has topped off and is dropping, the CPI will appear to benefit the tenant. Also, a shock to local rental market conditions, such as overbuilding or the exodus of a rental age or business group, can completely eliminate inflationary and interest rate effects on rent.

Alternatives to the CPI

Again, the CPI is a good method for controlling the *inflationary reduction of the purchasing power* of the U.S. dollar received in payment of rent.

Figure 2

Excerpt from Form 552-3

Commercial Lease

Net — Multi-Tenant

OPERATING EXPENSES:

5.1 Tenant is responsible for payment of utilities and services supplied to the Premises.

5.2 Tenant to pay all taxes levied on trade fixtures or other improvements Tenant installs on the Premises.

5.3 As additional base rent, Tenant to pay ______% of the real property taxes and assessments levied by governments, for whatever cause, against the land, trees and buildings within the Project containing the Premises, within 30 days after written demand from Landlord.

a. Tenant is not liable for increases in real property taxes and assessments resulting from a change in ownership.

5.4 If Landlord pays any charge owed by Tenant, Tenant will pay, within 30 days of written demand, the charge as additional rent.

5.5 As additional monthly base rent, Tenant to pay ______% of the common area maintenance (CAM) for the Project incurred each month, within 10 days of written statement and demand for payment.

a. CAMs are the cost to landlord of maintaining and operating the "Common Areas" of the Project, including all sidewalks, corridors, plazas, hallways, restrooms, parking areas, interior and exterior walls and all other open areas not occupied by tenants.

b. CAMs include all costs incurred by Landlord relating to the operation of the Project containing the Premises including hazard insurance premiums maintained by Landlord and charges for property management of the Common Areas.

Inflation's effect on rent amounts covered by the annual CPI adjustments is not the only concern of the property manager. Property appreciation and increased operating costs need to be managed to increase, or at worst maintain, the property's NOI, and thus the property's value.

It is advisable to add a **reappraisal** and rent adjustment provision to long-term leases rather than rely solely on the CPI. However, *reappraisal* methods are costly, time consuming and not always without argument. Managers may feel it is too involved to reappraise the property every few years to set the new rents.

Also, appraisal provisions usually call for a reappraisal and recast of the rent schedule at three- to five-year intervals or on exercise of renewal options when the rental rates are set to adjust to market rents. [See **RPI** Form 552 §4.5]

Upward shifts in rent

Some leases allow the landlord to use their judgment to set the rent for the adjustment, which needs to be exercised reasonably.

A provision for the periodic adjustment of rents to current rental rates is good insurance for a landlord. It captures any upward shifts in rents paid in the local rental market beyond those brought about by inflation.

This periodic recast of the rent payment is economically comparable to the rollover feature some lenders include in their three- or five-year adjustable rate or rollover mortgages.

In addition to base rents, CPI adjustments and rollover features, percentage rent provisions also capture the increase in rents due to appreciation based on a change in local demographics.

If the property is in an outstanding location, or promoted by the landlord resulting in an increase in the tenant's gross income, the landlord needs to consider negotiating a percentage rent adjustment provision to better "cash in" on the draw of the property's location.

Adjustments for operating expenses

Many commercial leases include an additional rent provision to reimburse the landlord for their operating expenses. Rent may be adjusted to include the operating expenses and any taxes and assessments incurred by the property, called **common area maintenance (CAM)** expenses. [See Figure 2]

CAM provisions obligate the tenant to pay a pro rata share of the costs to maintain the common areas of the property including:

- utilities (water, gas, heat, etc.);
- air conditioning and venting;
- sewage;
- garbage;
- janitorial services;
- landscaping;
- security;
- insurance premiums;
- management fees; and
- real estate taxes.

The more operating costs passed on to the tenant, the closer the lease comes to a full net lease.

Chapter 24 Summary

To increase rents annually for inflation, the lease needs to provide a formula for calculating rent increases.

A provision for the periodic adjustment of rents to current rental rates is prudent insurance for a landlord. It captures upward shifts in rents paid in the local rental market beyond those brought about by inflation.

The best method for coping with the uncertainty of future inflation is to tie the amount due as future rents to figures published in the federal government's consumer price index (CPI).

CPI figures are published monthly, bi-monthly or semi-annually by the U.S. Bureau of Labor Statistics for numerous metropolitan areas across the states. The CPI is the most widely used indicator of inflation.

Chapter 24 Key Terms

Chapter 25

Percentage lease rent provisions

Learning Objectives

After reading this chapter, you will be able to:

- implement the use of a percentage rent provision; and
- identify retail lease situations appropriate for using a percentage rent provision to set the amount of rent due.

Key Terms

base rent **percentage lease**

Rental income driven by gross sales

A landlord of a newly constructed commercial building negotiates a **percentage lease** with a prospective tenant. The prospective tenant intends to operate a franchised restaurant on the premises. They prepare an estimate of the gross sales amount anticipated for the first 12 months of operations, based on:

- the traffic count and traffic patterns at the location of the premises;
- the volume of anticipated sales; and
- the nature of the product and service to be offered by the restaurant.

The rent to be paid by the tenant comprises a **base rent** and additional rent.

The landlord and tenant agree the *base rent* for the first year, payable monthly, will be set at 6% of the tenant's estimated annual gross sales. The base rent is set in the lease agreement as a specific dollar amount. The monthly base rent amount is annually adjusted to increase at the rate of inflation as reflected by CPI figures.

The *percentage lease* agreement includes provisions for additional rent to be paid annually. The percentage rent provision is set to be triggered and additional rent due if 6% of the tenant's gross annual sales is greater in amount than the base rent paid during the preceding 12 months.

percentage lease
A commercial lease agreement for a retail operation that sets the total amount of rent the tenant will pay as a percentage of the tenant's gross sales. [See **RPI** Form 552-4]

base rent
The minimum monthly rent due under a commercial lease agreement. [See **RPI** Form 552 §4.3]

The percentage rates used to calculate the amount of additional rent to be paid for each consecutive 12-month period of the lease are set at:

- 6% of the first $2,000,000 in gross annual sales; and
- 7% on any greater amounts during the period.

From the total dollar amount calculated by these percentages, the *additional rent due* is the difference between the base rent paid during the 12 months and the total rent owed based on these percentages of gross annual sales. The additional rent is to be paid annually, within 45 days after the end of each 12-month period.

At the end of the first 12 months of business operation, the percentage rental rates are applied to the tenant's gross sales for the first year of occupancy. If the percentage amount is greater than the base rent paid, the tenant pays additional rent, also called percentage rent.

Base vs. percentage rent

The amount of rent paid for retail space in multiple tenant shopping complexes or other high traffic locations is based on a percentage of the tenant's gross sales. Lease agreements containing a percentage rent provision are called *percentage leases*. [See **RPI** Form 552-4]

A prudent landlord negotiating a percentage lease agreement includes as part of the rent provisions a clause calling for payment of a base rent. This base rent serves as a minimum monthly rent a tenant pays during each year of the lease. Base rent is payable monthly without regard to any amount of additional annual rent called for under the percentage rent clause. [See Figure 1]

The base rent is set by landlord/tenant negotiations, and is either:

- calculated as a percentage of the estimated gross sales the tenant will likely receive during the first year of operations; or
- based on current rents paid for comparable premises.

The monthly base rent is adjusted upward on each anniversary of the lease by either:

- pre-set increments, called graduated rent; or
- adjustments based on CPI figures, called adjustable rent.

The total amount of rent the tenant will actually pay monthly, quarterly or annually under a percentage lease is the greater of either the base rent or the percentage rent.

Typical percentage rent rates for satellite tenants in a large shopping complex are 4% or 10% of the tenant's gross sales. However, the percentages for gradations of sales depend largely on the type of merchandise and services sold by the tenant, the pricing and volume of these sales and the traffic count at the location. Well-branded heavy advertisers, called anchor tenants, pay lesser rates than satellite tenants who surround the large anchor tenants.

4.4 **ADDITIONAL PERCENTAGE RENT:** Additional percentage rent equal to ______% of gross sales income made from the Premises during each calendar year, less credit for base rent, real estate taxes, insurance, assessments and common area maintenance (CAM) charges paid by Tenant for the calendar year, is to be paid as described below:

a. The percentage rent due for each month of the lease will be paid and delivered with a signed written statement of the gross sales income and percentage computation by the tenth day of the following month.
b. The additional percentage rent computed for each month to be credited for base rent, taxes, insurance, assessments and CAMs paid by Tenant for the month.
c. Within one month after each calendar year and on expiration of the lease, Tenant to compute and deliver a written statement of the year's sales and the additional percentage rent calculated for the calendar year, less credit for base rent, taxes, insurance and CAMs paid for the calendar year, to annually determine the percentage rent remaining due from Tenant or to be refunded to Tenant by Landlord, which difference will be paid on delivery of the annual statement.
d. Gross sales income includes all money or equivalent received by Tenant, subtenant, licensees or concessionaires, in the ordinary course of business, whether wholesale or retail, cash or credit, less credit for goods returned by customers.
e. Landlord has the right, on reasonable notice, to audit Tenant's books regarding sales information.

Figure 1

Excerpt from Form 552-4

Commercial Lease Agreement — Percentage Lease

A tenant who retails small ticket items at high volume in a high traffic area, such as a kiosk in the center of a mall, will have a percentage rental rate, as high as 20% to 30% of sales.

Conversely, a tenant who retails big ticket items in low volume, such as an antique furniture store, will have a lower percentage rental rate.

When is percentage rent paid?

The tenant usually pays the additional percentage rent after the rental period has ended. The additional amount of the percentage rent is normally due within 10-to-45 days after the end of the period used to calculate the percentage rent.

Landlords and tenants agree to a monthly, quarterly, semi-annual or annual accounting period for payment of the percentage rent depending on:

- whether the tenant's sales tend to be constant or seasonal; and
- the financial strength of the tenant.

Further, percentage rent paid more than once a year is adjusted annually in a final accounting. This determines if any percentage rent remains due or is to be refunded to the tenant for the preceding 12 months of rental payments.

A landlord initially relies on their tenant to provide in good faith an accurate accounting of their gross sales for the period.

However, the landlord needs to reserve in the lease agreement the right to, on reasonable notice, audit the tenant's books regarding sales information and sales tax reports to the State Board of Equalization (SBOE). [See Figure 1]

Gross sales defined

The landlord and tenant also negotiate which sales will be subject to the percentage rental rate.

Gross sales is the actual price received for:

- all merchandise or services sold, leased, licensed or delivered in or from the premises by the tenant, for cash or on credit; and
- "layaway" sales at the time of the layaway transaction.

For the sale of lottery tickets, the tenant receives a 5% fee which is the amount included in the *gross sales*, not the price paid by the customer.[1]

Gross sales also include any sums received by the tenant for the licensing of vending machines, pay telephones, public toilet locks, etc., not the price paid to receive product from these machines.

For example, the tenant gives a vending machine operator the right to install vending machines on the leased premises for a one-time fee. The sums generated through the machine's sales are not included in gross sales since the tenant does not receive the sales proceeds.

Also, a periodic licensing fee received by a tenant from a vending machine operator for a license to use space is correctly considered part of the tenant's gross sales generated as a result of subleasing the premises.[2]

Further, money received by the tenant and disbursed while receiving no benefit, such as Medi-Cal funds received for direct disbursement to the staff as additional subsidized pay, is not included in the gross sales under a percentage lease. The funds did not increase the tenant's business, the tenant received no additions to sales and the funds were not for the tenant's use.[3]

The same exclusion rule applies to tips received by employees.

Excluded items

Items customarily excluded from gross sales in a percentage lease include:

- the selling price of merchandise returned for full credit;
- sums and credits received in the settlement of claims for damage to or loss of merchandise;
- sales tax;
- proceeds from the sale of fixtures, trade fixtures or other personal property used in the tenant's trade or business that are not merchandise;
- sales made to employees at a discount;
- refundable deposits; and
- uncollectible debts charged off by the tenant.

In practice, gift certificates are not considered part of the gross sales until they are redeemed and a sale is recorded.

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1 Calif. Government Code §8880.51

2 **Herbert's Laurel-Ventura** v. **Laurel Ventura Holding Corporation** (1943) 58 CA2d 684

3 **Western Medical Enterprises, Inc.** v. **Albers** (1985) 166 CA3d 383

Finance charges or interest on accounts receivable held by the tenant may or may not be included, depending on negotiations between the landlord and tenant, and whether the receivables are administered on or off the premises.

A fair rent for failure to use

A landlord enters into a percentage ground lease with a tenant who will build and operate a gas station on the premises. No provision requires the tenant to actually operate a gas station on the premises. The base monthly rent is set at $1,000 for the life of the lease without CPI or graduated adjustment. The percentage rent is set at 6.5% of gross sales.

The tenant builds and operates the gas station on the premises. Additional rent is paid since the amount of percentage rent always exceeds the base rent.

However, before the lease expires, the tenant closes the gas station. Then, the tenant pays only the base monthly rent since no sales exist. The base rent is significantly less than the percentage rent the tenant paid during the last year of operation.

The landlord claims the tenant owes them the percentage rent as if the tenant continued to operate their business on the premises.

The tenant claims they owe no more than the monthly base rent since the lease agreement does not contain a provision requiring the tenant to operate the gas station at all times during the term of the lease.

Is the tenant liable to the landlord for the same percentage rent owed the landlord if the tenant had continued operations on the premises?

Yes! An **implied covenant** exists in a percentage lease as a promise to continue to use the premises as anticipated by the lease agreement, when:

- the base monthly rent does not represent a fair return to the landlord; and
- the tenant decides not to operate their business on the property.[4]

Continual operation

By entering into a percentage lease, the tenant is expected to continually operate their business during the lease term.

However, due to changes in market conditions, demographics, traffic patterns or other economic factors, the base monthly rent originally negotiated in a percentage lease may not always represent a fair return to the landlord — a fair rental value for the premises.

The landlord relies on the percentage rent to provide a yield on their investment that will keep pace with local rental conditions in the future.

A tenant who ceases to use the property to operate the business as anticipated by the use provision in a percentage lease agreement still owes percentage

4 **College Block** v. **Atlantic Richfield Company** (1988) 206 CA3d 1376

rent. The amount due is based on the gross sales the tenant expected to experience had they continued to use the property as permitted by the lease agreement.

A prudent landlord includes a use provision in a percentage lease requiring the tenant to operate the business for the entire term of the tenancy.

Chapter 25 Summary

The amount of rent paid for retail space in multiple tenant shopping complexes or other high traffic locations is set as a percentage of the tenant's gross sales. Lease agreements containing a percentage rent clause are called percentage leases.

The amount of rent the tenant will actually pay monthly, quarterly or annually for the percentage rent is the greater of either the base rent or the percentage rent.

The base rent is set by landlord/tenant negotiations and either:

- set as the dollar amount of a percentage of the estimated gross sales the tenant will likely receive during the first year of operations; or
- set as a dollar amount based on rents currently paid for comparable premises.

The monthly base rent set for the first year is adjusted upward periodically, usually on each anniversary of the lease by either:

- pre-set increments, called graduated rent; or
- adjustments based on CPI figures, called adjustable rent.

Chapter 25 Key Terms

Chapter 26

Commercial use-maintenance provisions

Learning Objectives

After reading this chapter, you will be able to:

- act on provisions in a commercial lease regarding the performance of tenant and landlord responsibilities for the use and maintenance of the leased premises; and
- explain the remedies available to the landlord if a tenant fails to fulfill their use and maintenance obligations.

Key Terms

appurtenance

compliance-with-laws clause

destruction provision

hold harmless provision

rent provision

right-to-enter provision

signage provision

tenant improvements and alterations clause

triple-net lease

use-maintenance provision

use-of-premises provision

waste provision

Shifting ownership obligations to tenants

A commercial lease agreement contains two basic categories of provisions establishing the tenant's obligations to the landlord:

- *rent provisions* for the payment of amounts owed; and
- *use-maintenance provisions* for the use, care and preservation of the grounds and improvements.

Rent provisions evidence the promise to pay money owed to the landlord in exchange for the tenant's exclusive possession of the leased premises. This monetary obligation is separately enforceable from the use-maintenance provisions.

rent provision
A provision contained in a lease agreement establishing the tenant's obligations to pay rents for occupancy and use of the premises leased. [See **RPI** Form 552 §4]

use-maintenance provision
A provision in a commercial lease agreement which establishes the landlord's and tenant's responsibility for the care and maintenance of the premises during the lease term.

Use-maintenance provisions in a commercial lease agreement establish whether the landlord or the tenant is responsible for the care and maintenance of the premises during the lease term. [See **RPI** Form 552]

Use-maintenance obligations are unrelated to the payment of rent. Instead, they identify who will perform or contract for the repairs and maintenance of the leased premises and who will pay for the services — the landlord or the tenant.

If the landlord retains the majority of the maintenance obligations such as under a gross lease agreement, the **base rent** the tenant will pay will likely be higher than on a net lease. If the tenant assumes the majority of the maintenance obligations such as under a net lease agreement, the base rent the tenant pays will likely be lower than on a gross lease.

Just as a tenant breaches a lease agreement by failing to pay rent, they also breach the lease agreement when they fail to perform, or violate a use-maintenance provision.

The tenant's breach of an essential use-maintenance obligation triggers enforcement action by the landlord by serving the tenant with either:

- a three-day *notice to perform or quit* stating precisely what is to be done by the tenant within three days; or
- a three-day *notice to quit* if the breach is incurable.

Recall that when the performance called for in the notice to eliminate a curable breach is not completed prior to expiration of the notice period, the tenant loses their right of possession (provided the notice contains a declaration of forfeiture). When the notice to quit addresses an incurable breach, the tenant automatically loses any right to continue in possession at the time of the breach.[1]

Which use-maintenance provisions to include

The contents of each provision in a commercial lease agreement are fully negotiable. The results of negotiations depend on the respective bargaining power of the landlord and the tenant, as tempered by market conditions and the leasing agents involved.

As with any negotiations, lease provisions vary, depending on the:

- intended use of the property;
- delegation of operating costs and responsibility for the property's physical conditions and any TIs required; and
- length of the lease term.

Occasionally, professional landlords and franchised tenants will use a lease agreement form especially prepared by their respective attorneys for repetitive use, i.e., when the landlord has many properties to let or the tenant leases many locations.

1 **Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488

7. USE OF THE PREMISES:

7.1 The Tenant's use of the Premises will be ______________________.

7.2 No other use of the Premises is permitted.

a. Tenant may not conduct any activity which increases Landlord's insurance premiums.

7.3 Tenant will not use the Premises for any unlawful purpose, violate any government ordinance or building and tenant association rules, or create any nuisance.

7.4 Tenant will not destroy, damage, or remove any part of the Premises or equipment, or commit waste, or permit any person to do so.

Figure 1

Excerpt from Form 552

Commercial Lease Agreement

Gross — Single Tenant

However, landlords more frequently use published lease agreements that contain provisions basic to commercial lease transactions. They then attach addenda for provisions not included in the form or contrary to provisions in the form. [See **RPI** Form 552 through 552-8]

*Editor's note — The following discussion of use-maintenance clauses refers to provisions in **RPI** Form 552 — Commercial Lease Agreement — Gross — Single Tenant.*

Use of the premises provision

On entering into a commercial lease agreement, a landlord and tenant agree the premises will be used by the tenant for a single specified purpose, such as a retail clothing store or an auto mechanics shop. This purpose is specified in the **use-of-premises provision**. [See **RPI** Form 552 §7.1; see Figure 1]

use-of-premises provision
A provision contained in a commercial lease agreement which establishes the single specified purpose for the tenant's use of the leased premises.

When lease provisions do not restrict or specify the tenant's use of the leased premises, the premises may be used for any lawful purpose.[2]

Conversely, a lease may prohibit any change in use, or set conditions to be met before a change from the use specified in the *use-of-premises provision* may be implemented.[3]

If the use provision requires the landlord's consent to a change in use, but gives no standard or condition to be met for the consent, the landlord needs evidence of a commercially reasonable basis for withholding their consent to the tenant's proposed new use.[4]

The standard of reasonableness applied to the landlord's consent is the same as applied to assignment and subletting restrictions — *restriction-on-transfer provisions* — calling for the landlord's consent.

In the *use-of-premises provision*, the tenant agrees to deliver up the premises on expiration of the lease in as good condition as it was when they took possession, less reasonable wear and tear.

Even if the tenant's use of the leased premises is unrestricted, the tenant cannot impair the premises by damaging it, creating a nuisance, engaging in illegal activities or subjecting the premises to greater wear and tear than the use contemplated when the lease was entered into. [See Figure 1 §7.4]

2 Calif. Civil Code §1997.210(b)
3 CC §1997.230
4 CC §1997.250

Figure 2

Excerpt from Form 552

Gross — Single Tenant

10. SIGNS AND ADVERTISING:

10.1 Tenant will not construct any sign or other advertising on the Premises without the prior consent of Landlord.

10.2 ☐ Landlord will maintain a directory in the lobby of the Premises displaying the name and suite number of Tenant. Landlord has the right to determine the size, shape, color, style and lettering of the directory.

10.3 ☐ Landlord will provide a sign to be placed on the primary door to Tenant's suite. The fees for the cost and installation will be paid by Tenant.

In addition to the use allowed, the tenant agrees not to conduct any activities on the property which:

- increase the landlord's liability or hazard insurance premiums; or
- violate any laws, building ordinances or tenant association rules, called a *compliance-with-laws clause*. [See Figure 1]

Appurtenances to the leasehold

appurtenance
A right belonging to real estate owned by the landlord to use property located outside the leased premises for purposes such as parking or access.

Property or rights belonging to but not located within the leased space are called **appurtenances**. A tenant's use of appurtenances is often necessary for the use and enjoyment of the space leased.[5]

Leasehold *appurtenances* include rights belonging to real estate owned by the landlord and located outside the leased space, such as:

- a right of way for vehicular travel through an industrial or office complex;
- parking for employees and customers;
- storage space, lobbies and restrooms; and
- access by ingress and egress from public roads to the leased premises, such as a road or driveway.

Signs and advertising for conformity

A **signage provision** in the lease agreement gives a landlord control over the size, style, content and location of signs constructed or installed on the premises to advertise the location or existence of the tenant's business. This allows the landlord to maintain the integrity of the building's physical and aesthetic appearance. [See **RPI** Form 552 §10; see Figure 2]

The cost of sign installation can be charged to either the landlord or tenant as negotiated and stated in the terms of the lease.

Tenant improvements and alterations

A tenant's right to make alterations or further improve the premises during the tenancy is governed by the lease provision called **tenant improvements (TIs) and alterations clause**, or more simply a *TI clause*. [See **RPI** From 552 §11; see Figure 3]

To ensure the landlord retains control over the structures on the leased premises, the tenant agrees not to alter or further improve any part of the

5 CC §662

11. TENANT IMPROVEMENTS/ALTERATIONS:

11.1 Tenant may not alter or improve the Premises without Landlord's prior consent to include tenant improvements necessary for Tenant to occupy.

a. Tenant will keep the Premises free of all claims for any improvements and will timely notify Landlord to permit posting of Notices of Nonresponsibility

11.2 Any increases in Landlord's property taxes caused by improvements made by Tenant will become additional rent due on demand.

11.3 On expiration of this lease, tenant improvements as authorized by Landlord are to:

a. ☐ become fixtures and part of the Premises not to be removed by Tenant.

b. ☐ be removed by Tenant in their entirety.

c. ☐ be partially removed by Tenant as follows: ____.

Figure 3

Excerpt from Form 552

Gross — Single Tenant

building without first obtaining the landlord's written consent. The tenant will pay all costs incurred in the construction (unless the lease agreement is altered to call for different treatment).

A lease agreement for retail space, especially in malls, includes provisions which require the tenant to renovate their storefront and interior every number of years. Renovations by tenants every four to six years will help maintain a fresh appearance which is vital to the overall success of retail shopping centers.

signage provision
A provision in a commercial lease agreement which gives the landlord control over the size, style, content and location of signs constructed or installed on the leased premises. [See **RPI** Form 552 §10]

When the landlord later consents to alterations by the tenant, the tenant is to promptly notify the landlord of the commencement of construction so the landlord can post and record a **notice of nonresponsibility**.

The *notice of nonresponsibility* is a form which releases the landlord from responsibility for any claims made by contractors for improvements the contractors construct on the leased premises under their contract with the tenant.[6] [See **RPI** Form 597]

tenant improvements and alterations clause
A clause in a commercial lease agreement which specifies the tenant's right to make alterations or further improve the premises during the tenancy. [See **RPI** Form 552 §11]

The notice bars *mechanic's liens* on the landlord's fee interest and denies contractors employed by the tenant the ability to pursue the landlord for unpaid amounts due.

Increases in property taxes due to alterations made by the tenant are the tenant's responsibility and are to be paid to the landlord on demand.

Unless otherwise agreed, tenant improvements become the property of the landlord at the end of the lease term and cannot be removed by the tenant, with the exception of the tenant's trade fixtures.[7]

Further, when the tenant alters or improves the premises resulting in a new and different use of the premises, the tenant has a duty to comply with all building code requirements. This responsibility is separate from the contractual duty imposed by a **compliance-with-laws clause**. [See Figure 1 §7.3]

compliance-with-laws clause
A provision in a commercial lease agreement controlling the conduct of tenant activities on the property to conform with public laws, building ordinances or tenant association rules. [See **RPI** Form 552 §7.3]

If the tenant's installation of improvements violates building codes and ordinances, the tenant will be liable for the costs the landlord incurs to conform the tenant-installed improvements to codes and ordinances.[8]

6 CC §8444
7 **Wolfen** v. **Clinical Data, Inc.** (1993) 16 CA4th 171
8 Wolfen, *supra*

Government-ordered repairs

When determining whether the landlord of the tenant is responsible for government-ordered repairs, the terms of the lease agreement do not always control. Instead, the determination of whether the landlord or the tenant is to bear the burden of government-ordered repairs is based on the analysis of six factors:

- *the ratio of the cost of repairs to the amount of rent due over the entire life of the lease;*
- *the length of the lease, including renewal options;*
- *whether the landlord or the tenant will benefit more from the repairs in terms of the useful life of the building and the remaining term of the lease;*
- *whether the repairs are structural or nonstructural;*
- *whether or not the repairs will substantially interfere with the tenant's enjoyment of the premises; and*
- *whether or not the government-ordered repairs were foreseeable at the time the lease agreement was entered into by the landlord and the tenant.*

Each burden-of-compliance factor is weighed based on the circumstances surrounding the execution of the lease agreement, the text of the lease provisions and the economic realities of the lease transaction.

For example, a landlord and tenant enter into a 15-year commercial net lease agreement. A boilerplate use-maintenance provision transfers to the tenant all ownership duties, including structural repairs.

Less than two years into the 15-year lease, the county discovers friable asbestos on the premises and issues an abatement order to the tenant. Neither the landlord nor the tenant had previous knowledge asbestos existed on the premises as it was a pre-existing condition of the building. The tenant seals off the contaminated area and conducts business out of another section of the building.

The costs of repairing the building is a sum roughly equal to 5% of the aggregate amount of rent due over the entire 15-year life of the lease.

Here, the provisions in the lease agreement and the circumstances under which the lease was entered into imply the duty to comply with the government order was transferred to the tenant, since:

- *the cost of repairs amounted to less than 5% of the aggregate amount of rent due over the life of the lease;*
- *the lease was for 15 years, thus the cost of repairs are easily amortized by the tenant during the remaining tenancy;*

Who does the repair and maintenance?

The tenant's responsibilities for the payment of the costs to repair and maintain the premises are of equal financial importance and effect as the amount of rent to be paid under a commercial lease agreement. Ultimately, the tenant bears them, either directly by incurring the costs or indirectly through the payment of basic rent or additional rent in the form of *common area maintenance charges (CAMs).*

The extent of the maintenance and repair obligations assumed by the tenant depends on the type of space leased, the length of the lease term and of course market conditions of inventory and users — supply and demand issues.

Government-ordered repairs

Cont'd

- *the asbestos removal most benefits the tenant since the contamination was discovered less than two years into the lease;*
- *the repairs are structural and the lease clearly transfers structural repairs to the tenant;*
- *the tenant's use of the premises is not greatly interfered with during the abatement; and*
- *neither the tenant nor the landlord had reason to believe asbestos existed on the premises, yet the tenant was experienced in retail leasing and elected not to investigate the premises. [**Brown** v. **Green** (1994) 8 C4th 812]*

Now consider a landlord and a tenant who enter into the same commercial net lease agreement but for a term of three years. The lease also contains an option to renew the lease for five additional years. The net lease agreement contains the boilerplate compliance-with-laws and use-maintenance provisions which shift the duties of ownership to the tenant. Under these provisions, the tenant has the duty to complete structural repairs.

After the tenant exercises their option to renew the lease for the additional five years, the landlord receives a compliance order from the city requiring the leased premises to be earthquake-proofed.

The cost of earthquake-proofing the building roughly equals 50% of the aggregate amount of the rent due over the entire life of the lease, which is now in its 4th year.

Here, even though the lease agreement shifted the major burdens of ownership from the landlord to the tenant, an application of the six-factor test determines the landlord bears the burden of the earthquake-proofing costs. The analysis found that:

- *the cost of earthquake-proofing the premises was roughly equal to 50% of the aggregate rent due over the total eight-year term of the lease;*
- *the eight-year lease was short-term with little time remaining for the tenant to amortize the cost of the repairs; and*
- *the earthquake-proofing primarily benefited the landlord since only a short term remained on the tenant's lease. [**Hadian** v. **Schwartz** (1994) 8 CA4th 836]*

Thus, when entering into a commercial net lease agreement, a landlord is best served considering the inclusion of a provision calling for the tenant to assume the cost of compliance orders that do not regulate the tenant's use of the premises — government-ordered retrofitting or renovation.

Yet the landlord needs to be aware that if the economic realities of the lease agreement are not in accord with the text of the lease agreement, the landlord may still be liable for government-ordered repairs.

The longer the lease term, including renewal options, the more likely the obligations for maintenance will be shifted to the tenant. The shift will be even more likely if the premises is a single-user building, such as a warehouse or bank building as opposed to a multi-tenant project.

The commercial tenant has a duty during the leasing period to notify the landlord of those repairs which are needed and are the responsibility of the landlord.

Compliance-with-laws clause

Some net lease agreement forms contain a *compliance-with-laws clause* requiring the tenant to make any government-ordered repairs, such as asbestos removal or seismic retrofitting.

If the lease agreement containing a compliance clause is a short-term lease agreement, the landlord will be the primary beneficiary of the government-ordered repairs. In spite of the wording in the lease agreement placing the financial responsibility on the tenant, the landlord may be responsible for completing and paying for government-ordered repairs.[9] [See Sidebar, "Government-ordered repairs"]

Net lease agreements contain various provisions covering the cost of items needing repair, replacement or maintenance which exceed one month's rent. [See **RPI** Form 552-2 and 552-3]

When the cost of tenant obligations for repair and maintenance of an item exceeds the equivalent of one month's rent, the landlord performs the repairs. The cost for the repairs is initially paid by the landlord.

In turn, these provisions obligate the tenant to reimburse the landlord by payment of a monthly additional amount of rent equal to 1/144 of the cost the landlord incurred. The additional rent is paid each month for the remainder of the term of the lease agreement and any lease extensions, but not to exceed 144 months. [See **RPI** Form 552-2 §6.3]

Thus, costly repairs are allocated between the tenant and landlord over 144 months. Further, interest is paid by the tenant on the total amount remaining to be reimbursed over the 144 months at an annual rate set in the provision. To require the tenant to replace an item which is costly in the last couple of months of a lease is unenforceable since the tenant will bear all the cost and receive none of the benefits. [See **RPI** Form 552-2 §6.3]

Landlord's right to enter limited

Once a tenant acquires a leasehold interest in a commercial premises, the landlord no longer has the right to enter the premises for any reason, unless agreed to the contrary or an emergency exists.

However, the landlord can reserve the right to enter and make any necessary repairs, alterations or inspections of the premises by including a **right-to-enter provision** in the lease agreement. [See **RPI** Form 552 §12; see Figure 4]

right-to-enter provision
A provision contained in a lease agreement which reserves to the landlord the right to enter the leased premises to make necessary repairs, alterations or inspections. [See **RPI** Form 552 §12]

A landlord may need to enter the premises when:

- the landlord makes necessary or agreed-to repairs or alterations;
- the landlord is supplying necessary services to the tenant;
- the landlord shows the premises to a prospective tenant;
- the tenant has abandoned or surrendered the premises;
- the tenant requests a pre-expiration inspection;
- a court order was issued allowing the landlord to enter; or
- an emergency exists which endangers the property.

9 **Hadian** v. **Schwartz** (1994) 8 C4th 836

Figure 4

Excerpt from Form 552

Gross — Single Tenant

12. RIGHT TO ENTER:

12.1 Tenant agrees to make the Premises available on 24 hours' notice for entry by Landlord for necessary repairs, alterations, or inspections of the Premises.

Waste as a permanent breach

As is expected in a lease agreement, the tenant agrees not to destroy, damage or remove any part of the premises or equipment, or permit or commit waste on the premises. This clause is called the **waste provision**. [See **RPI** Form 552 §7.4; see Figure 1]

waste provision
A provision in a lease agreement in which the tenant agrees not to destroy, damage or remove any part of the leased premises. [See **RPI** Form 552 §7.4]

If the tenant or a person permitted on the premises by the tenant commits waste to the property, the tenant commits an incurable breach of the lease agreement and automatically forfeits their right of possession.

The landlord may serve the tenant who has committed or permitted waste to the property with a three-day notice to quit as required to initiate an *unlawful detainer (UD)* action to evict the tenant if they do not vacate.[10]

Liability insurance

A landlord and tenant may agree the tenant will purchase a liability insurance policy to cover losses which might occur on the premises, including:

- property damage; and
- bodily injury. [See **RPI** Form 552 §13; see Figure 5]

The lease agreement sets the policy limits or minimum amount of liability insurance the tenant is to obtain. These limits are set as a result of the landlord's discussion and analysis with an insurance agent. [See Figure 5]

Typically, a tenant's obligation to maintain liability insurance under a lease is covered under the tenant's commercial general liability insurance policy purchased by the tenant to insure the business they operate on the premises.

To protect the landlord from any dissipation of insurance proceeds by the tenant, the landlord is to be named as an additional insured on the tenant's liability and hazard insurance policies covering the leased premises.

A landlord ensures they are named on the insurance policy by drafting the lease agreement to require the tenant to provide a certificate of insurance from the carrier naming the landlord as an additional insured. [See Figure 5 §13.3]

10 Calif. Code of Civil Procedure §1161(4)

Figure 5

Excerpt from Form 552

Gross — Single Tenant

13. LIABILITY INSURANCE:

13.1 Tenant will obtain and maintain commercial general liability and plate glass insurance coverage insuring Tenant and Landlord against all claims for bodily injury, personal injury and property damage arising out of Tenant's use of the Premises.

13.2 Tenant to obtain insurance for this purpose in the minimum amount of $__________________.

13.3 Tenant to provide Landlord with a Certificate of Insurance naming Landlord as an additional insured. The Certificate is to provide for written notice to Landlord if a change or cancellation of the policy occurs.

13.4 Each party waives all insurance subrogation rights they may have.

Under the insurance provision, both the landlord and the tenant waive any insurance subrogation rights each might have against the other. Due to the clause, an insurance carrier cannot seek to recover from the landlord or tenant who was the cause of the injury or property damage.[11]

Hazard insurance

In a multi-tenant building, a landlord obtains a hazard insurance policy and passes the cost of the premiums through to the tenant, generally by way of the monthly base rent or CAMs.

The landlord and tenant may agree the tenant will purchase a standard hazard insurance policy for fire losses. It also covers theft and vandalism of all personal property and the restoration of tenant improvements, including the destruction of plate glass windows.

Requiring the tenant to maintain a hazard insurance policy assures the landlord that the tenant will be in the financial position necessary to continue to operate their business if fire, theft or vandalism occurs during the term of the lease.

When the tenant is required to maintain an insurance policy for property damage resulting from fire, theft or vandalism, the landlord is named by the carrier as an additional insured. Thus, the landlord controls the use of any insurance proceeds.

triple-net lease
A commercial lease which passes the responsibility for all costs and maintenance of the property to the tenant. [See RPI Form 552-2 and 552-3]

In a long-term, **triple-net lease** where the tenant has assumed all obligations and duties of ownership, the lease agreement shifts to the tenant:

- the obligation to maintain hazard insurance; and
- the burden of repairing any destruction of the real estate, regardless of the cause.

Hold harmless for tenant's actions

The *hold harmless provision* covers the landlord for liability from injuries occurring on the premises which:

- arise out of the tenant's negligent use of the premises; and
- are caused by the tenant, their employees or customers due to the tenant's negligence. [See **RPI** Form 552 §15; see Figure 6]

11 **Gordon** v. **J.C. Penney Company** (1970) 7 CA3d 280

Figure 6

Excerpt from Form 552

Gross — Single Tenant

15. HOLD HARMLESS:

15.1 Tenant will hold Landlord harmless for all claims, damages or liability arising out of the Premises caused by Tenant or its employees or patrons.

When a **hold harmless provision** is included in a lease agreement, the tenant needs to purchase liability insurance coverage for the risk of loss they have agreed is theirs — their contractual liability under the lease agreement. [See Figure 6]

hold harmless provision
A provision in a lease agreement that shifts liability from the landlord to the tenant for injuries occurring on the premises caused by the tenant's negligence. [See **RPI** Form 552 §15]

Contractual liability insurance is separate from general liability insurance covering bodily injury and property damage.

Regardless of the type of hold harmless provision used, the landlord cannot shift responsibility to the tenant for any liability arising from their landlord's intentional misconduct or violation of law.[12]

For example, a landlord cannot escape liability to others for injuries occurring on the leased premises due to the landlord's failure to maintain the premises.

Destruction and who must repair

Initially, the responsibility for the costs of making repairs to commercial property lies with the landlord.

However, some or all of the responsibilities may be shifted to the tenant through negotiations. They are also allocated between the landlord and the tenant by a *destruction provision* in the lease agreement.

In the destruction provision, the tenant agrees to repair and pay for any destruction to the premises:

- caused by the tenant;
- covered by insurance policies held by the tenant; or
- required by other lease provisions.

When the tenant is obligated to carry insurance covering the cost of repairs, the landlord named as an additional insured controls the disbursement of any insurance proceeds available to pay for the repairs. [See **RPI** Form 552 §16; see Figure 7]

destruction provision
A provision in a lease agreement in which a tenant agrees to pay for any destruction to the premises caused by the tenant, covered by the tenant's insurance or required by other lease provisions. [See **RPI** Form 552 §16]

On the other hand, the landlord agrees to repair and pay for any damage to the premises which:

- is not caused by the tenant or covered by the tenant's insurance policies;
- is insured only by the landlord's policy; or
- is not insured by any policy. [See Figure 7 §16.2]

12 CC §1668

Figure 7

Excerpt from Form 552

Gross — Single Tenant

16. DESTRUCTION:

16.1 In the event the Premises are totally or partially destroyed, Tenant agrees to repair the Premises if the destruction is caused by Tenant or covered by Tenant's insurance.

16.2 Landlord will repair the Premises if the cause is not covered by Tenant's insurance policy and is covered by Landlord's insurance policy.

16.3 This lease agreement may not be terminated due to any destruction of the Premises, unless:

a. the repairs cannot be completed within 30 days;
b. the cost of restoration exceeds 70% of the replacement value of the premises;
c. the insurance proceeds are insufficient to cover the actual cost of the repairs; or
d. the Premises may not be occupied by law.

A **destruction provision** typically states the lease will not terminate due to any destruction of the premises, unless the landlord chooses to terminate it under specified conditions, such as:

- the repairs cannot be completed within 30 days;
- the cost of restoration exceeds 70% of the replacement value of the premises;
- the insurance proceeds are insufficient to cover the actual cost of the repairs; or
- the premises may not be occupied by law. [See Figure 7]

Thus, the landlord may opt to terminate the lease if the casualty is underinsured.

However, if the landlord fails to begin repairs which are their responsibility or, alternatively, terminates the lease within a reasonable time, the tenant may:

- abandon the premises due to a *constructive eviction* and be excused from further performance under the lease[13]; or
- pay rent and recover from the landlord any losses suffered due to the landlord's failure to repair.[14]

---

13 CC §1942
14 **Ng** v. **Warren** (1947) 79 CA2d 54

Chapter 26 Summary

A commercial lease agreement contains two basic categories of provisions establishing the tenant's obligations to the landlord:

- rent provisions for the payment of amounts owed; and
- use-maintenance provisions for the use, care and preservation of the grounds and improvements.

Use-maintenance obligations are unrelated to the payment of rent. Use-maintenance provisions in a commercial lease agreement establish whether the tenant or the landlord is responsible for the care and maintenance of the premises during the lease term.

Just as a tenant breaches a lease agreement by failing to pay rent, they also breach the lease agreement when they fail to perform, or violate a use-maintenance provision.

The tenant's breach of an essential use-maintenance obligation triggers enforcement action by the landlord by serving the tenant with either:

- a three-day notice to perform or quit stating what needs to be done by the tenant within three days; or
- a three-day notice to quit if the breach is incurable.

Chapter 26 Key Terms

Chapter 27

Lease renewal and extension options

Learning Objectives

After reading this chapter, you will be able to:

- distinguish between a renewal and extension of a lease; and
- take the proper steps to exercise an option to renew or extend a lease

Key Terms

option to extend	**option to renew**

Don't forget to exercise

A broker arranges for a tenant to lease improved commercial real estate. The lease is for a three-year term and contains options to renew the lease for additional three-year periods to avoid violation of the **due-on clause** in a trust deed encumbrance. [See **RPI** Form 552]

The lease renewal options require the tenant to exercise each renewal option in writing at least three months before the lease term expires. Otherwise, the renewal options expire three months before the lease itself expires. [See Form 566 accompanying this chapter]

During occupancy, the tenant's business improves. As a result, they make substantial improvements to the building with the owner's consent.

Business demands require the tenant to also lease an adjacent building. The two buildings are operated as one complex by the tenant. The cul-de-sac street fronting the building is even renamed after their business.

As the expiration date of the renewal option approaches, the tenant installs new air conditioning units, again with the owner's consent.

However, the tenant fails to give the owner the written notice required to exercise their option to renew the lease before the renewal option expires.

After the option expires, but before the lease expires, the tenant attempts to exercise the renewal option.

The owner refuses to waive or extend the expiration date of the option to renew. The tenant is told they need to vacate on expiration of the current three-year term since the renewal option expired unexercised.

The tenant claims their tenant improvement activity was sufficient to place the owner on notice of their intent to exercise the renewal option since their improvements were inconsistent with vacating the premises on expiration of the lease.

When the option to renew expires unexercised as agreed, does the lease automatically expire at the end of its term?

Yes! The tenant's further improvements of the premises prior to expiration of the renewal option are not proper notice to the owner of the tenant's intent to renew. An option is an irrevocable offer, separate and independent of the lease agreement, whether it is a provision in the lease agreement or an addendum to it. [See Form 565 accompanying this chapter]

An option expires by its own terms, as does any offer. If acceptance is not given by exercise as specified in the option agreement, the option expires.[1]

The lease term

Absent an agreement to the contrary, a lease terminates automatically, without further notice, on expiration of the lease term stated in the lease agreement.[2]

A tenant who remains in possession after the lease term expires is commonly referred to as a **holdover tenant**, legally called a **tenant at sufferance**.

A landlord subjected to a holdover may initiate an unlawful detainer proceeding to evict the holdover tenant immediately after expiration of the lease — no notice to quit is necessary.[3]

Alternatively, when a renewal option does not exist and the tenant continues in occupancy and tenders rent which the landlord accepts, a month-to-month tenancy is created. Consequently, the landlord needs to serve the tenant with the appropriate notice to vacate to terminate the periodic tenancy.[4]

Options to renew/extend

Frequently, lease agreements contain provisions or addendums which allow the tenant to continue in lawful possession after the initial lease term expires. A prior agreement allowing continued occupancy is called an **Option to Renew/Extend the Lease**. [See Form 565]

For a tenant, a lease renewal/extension option can be financially advantageous. The tenant has time during the option period to examine

1 **Bekins Moving & Storage Co.** v. **Prudential Insurance Company of America** (1985) 176 CA3d 245

2 Calif. Civil Code §1933(1)

3 Calif. Code of Civil Procedure §1161(1)

4 CC §§1945, 1946

Form 565

Option to Renew/Extend Lease

Page 1 of 2

OPTION TO RENEW/EXTEND LEASE

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

NOTE: This form is used by a leasing agent or landlord when negotiating a residential or commercial lease agreement, to provide in an addendum the landlord's grant to the tenant the option to extend possession under the original lease agreement or renew under a new lease agreement on the same conditions as the expiring lease.

DATE: ____________, 20______, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This option to renew or extend is an addendum to the lease agreement

1.1 dated ______________, 20_____, at ______________________________________, California,
1.2 entered into by ____, as the Tenant,
1.3 and ____, as the Landlord,
1.4 recorded ____________________, 20______, as Instrument No. __________________________,
1.5 in ______________________________________ County, California, regarding real estate referred to as
____.

AGREEMENT:

2. Landlord hereby grants to Tenant the following option(s) to ☐ renew, or ☐ extend, the term of the lease agreement referenced above.

2.1 The first option is for a term beginning on expiration of the original term of the lease and ending ______ year(s) thereafter.
The rental payment schedule during the term of this renewal/extension to be ________________________
____.

2.2 The second option is for a term beginning on expiration of the immediately preceding term and ending ______ year(s) thereafter.
The rental payment schedule during the term of this renewal/extension to be ________________________
____.

2.3 The third option is for a term beginning on expiration of the immediately preceding term and ending ______ year(s) thereafter.
The rental payment schedule during the term of this renewal/extension to be ________________________
____.

2.4 Other ____
____

3. Each option to renew/extend the lease expires _____ months prior to the expiration of the lease term which immediately precedes the renewal/extension period provided by the option.

4. A written notice of Exercise of Option to Renew/Extend Lease needs to be delivered prior to expiration of the option exercised and no sooner than ______ months before expiration of the option exercised. [See **RPI** Form 566]

4.1 Exercise of each option to be delivered to Landlord by certified mail or personal delivery, or by personal delivery to Broker/Property Manager who is ____.
Address ____

4.2 Tenant's failure to timely exercise any option will cause the lease to expire unrenewed and unextended.

PAGE 1 OF 2 — FORM 565

whether the economic and financial conditions of their trade or business at this location favor an exercise of the option and continued possession. If not, the tenant is under no obligation to exercise the option. If they do not exercise the option, they need to vacate the premises on expiration of the lease.

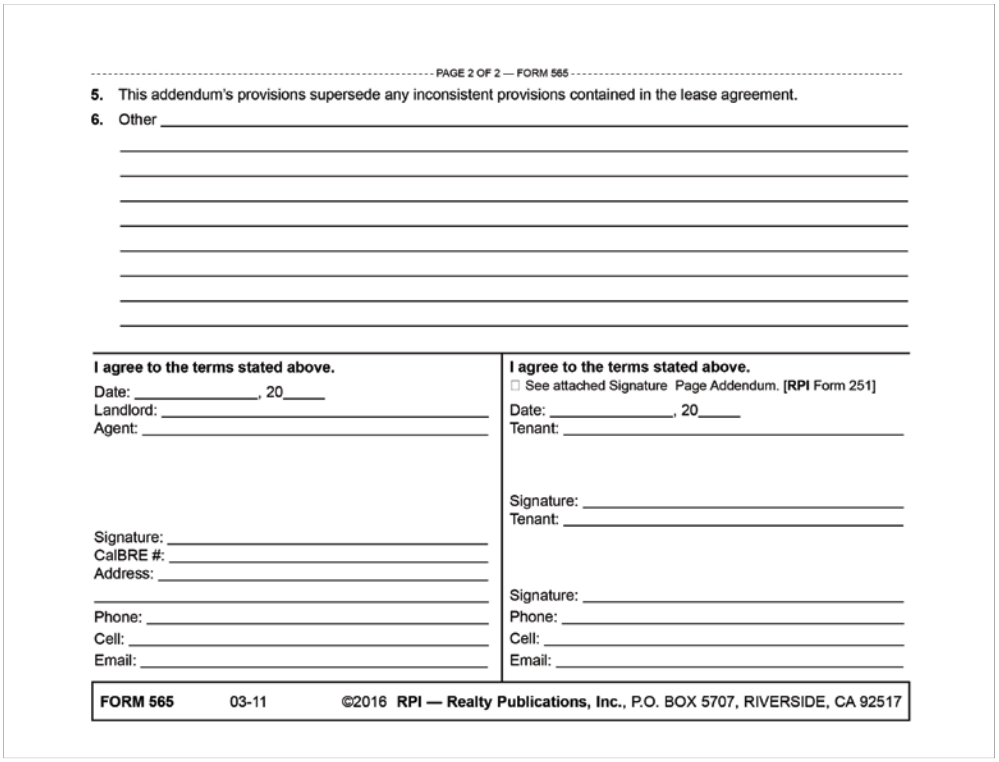
Thus, the well-informed tenant will consider negotiating one or more renewal/extension options when entering into a lease agreement for a short term.

On the other hand, the landlord may not share the tenant's enthusiasm for a renewal/extension option since the decision seems to only benefit the tenant. A renewal/extension option leaves the landlord in a somewhat uncertain

Form 565

Option to Renew/Extend Lease

Page 2 of 2


PAGE 2 OF 2 — FORM 565

5. This addendum's provisions supersede any inconsistent provisions contained in the lease agreement.

6. Other ______

I agree to the terms stated above.	I agree to the terms stated above. ☐ See attached Signature Page Addendum. [RPI Form 251]
Date: ______, 20____	Date: ______, 20____
Landlord: ______	Tenant: ______
Agent: ______	Signature: ______
Signature: ______	Tenant: ______
CalBRE #: ______	Signature: ______
Address: ______	Phone: ______
Phone: ______	Cell: ______
Cell: ______	Email: ______
Email: ______	

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position as they do not know who will occupy the premises in the future. Meanwhile, the tenant is left to decide whether to exercise the option and extend the occupancy or vacate on expiration of the lease.

Future uncertainty

One solution to the landlord's anxiety about locating a new tenant is to set the expiration of the renewal/extension option several months before the lease expires. Thus, the expiration of the option unexercised gives the landlord sufficient time in which to locate a replacement tenant. [See Form 565 §3]

A renewal option encourages a tenant to enter into the lease in the first place since the tenant has the right to continue in possession if the property proves beneficial to their business. Additionally, the renewal/extension option encourages the tenant to improve and promote the location in anticipation of remaining in possession. Also, three-year terms do not violate the due-on clause in any trust deed encumbering the property.

Consider a lease agreement which grants a tenant an option to renew the lease every three years at the same rental rate. It does not state a date for expiration of the continuing option renewal periods. When the tenant attempts to exercise the renewal option, the landlord claims the lease is unenforceable since the lease agreement and the option grant the tenant the right to renew the lease forever — a violation of the rule against perpetuities.

However, the lease is valid. Commercial lease transactions are no longer controlled by laws governing perpetuities. The total term of the commercial lease, including extensions or renewals, is limited to 99 years by statute if not limited by its terms.[5]

Renew vs. extend

A technical but obvious processing distinction exists between a **renewal** and an **extension** of a lease.

An *extension* is a modification of the original lease term by extending its expiration date for an additional period. On the other hand, a *renewal* requires the execution of a new lease on identical conditions to the original lease agreement, not a continuation of the old lease.[6]

option to renew
An agreement granting a tenant the right to continue in possession upon expiration of the existing lease under a new lease agreement on the same conditions as the expiring lease agreement on terms for payment of rent set out in the option to renew. [See **RPI** Form 565]

A renewal involves the preparation and signing of a new lease which creates an entirely new tenancy. The new tenancy is subject to any change in law affecting the rights and obligations of the landlord or the tenant. It is also subordinate to any encumbrances which occurred during the term of the prior lease.

Alternatively, an extension merely modifies the original lease by extending its expiration date. Thus, the modified lease is not subject to changes in the law or encumbrances occurring after the term of the original lease.

However, the terms are often used interchangeably, neglecting to maintain clarity of purpose, legal rights and the paperwork involved.

option to extend
An agreement granting a tenant the right to extend possession under the original lease agreement on terms set out in the option to extend. [See **RPI** Form 565]

For instance, a lease agreement granting the tenant an "option to renew" which does not specify the manner or method for exercise of the option nor call for the signing of a new lease is considered an extension. As a result, the provisions of the original lease apply on exercise of the option, but with a new expiration date by modification.[7]

Exercise of the option

To exercise a lease renewal/extension option, the tenant needs to notify the landlord of their unqualified intention to renew or extend the lease on the terms in the option. The notice of exercise needs to be timely delivered to the landlord, unequivocal and precise in its terms for the specific period offered in the option. If not, the notice of exercise is ineffective and may be ignored by the landlord.

Consider a tenant who enters into a lease agreement which includes a provision or an attachment granting the tenant an option to renew the lease for an additional two-year period.

During the period for exercise of the renewal option, the tenant notifies the landlord of their intention to renew the lease, but notes they will only occupy for one year.

5 **Shaver** v. **Clanton** (1994) 26 CA4th 568
6 **In re Marriage of Joaquin** (1987) 193 CA3d 1529
7 In re Marriage of Joaquin, *supra*

In this example, the tenant's notice to renew is an ineffectual attempt to exercise the option to renew the lease. The tenant's notice is a proposal to renew for a different period than the period stated in the option — an irrevocable offer to renew the lease.

Thus, the notice is not an acceptance of the offer to renew housed in the option granted, but an attempt to alter the original terms of the option. Here, the communication constitutes a rejection of the offer in the original option. It is a counteroffer calling for an alternative performance by the tenant, not an unequivocal acceptance.[8]

Strict compliance

Also, when the renewal/extension option agreement specifies the steps to be taken and the time period in which they are to occur, the tenant needs to strictly comply if they intend to exercise the option.[9]

Usually, the tenant is required to give written notice of their exercise of the option several months before the current term of the lease expires (often a period of three to six months before the lease itself expires).

Advance notice requirements give the landlord ample time to locate a new tenant when the present tenant elects not to renew/extend the lease.

The option needs to state the method for delivery of the tenant's notice of their intent to exercise the option to renew/extend. Notice of exercise needs to be required in writing and personally handed or sent by certified mail to the landlord within a specific period of time, such as a three-month window six months prior to the lease's expiration.

If notice is to be delivered by certified mail, the risk of the notice being lost in the mail is on the landlord. When a receipt for certified mail is issued by the post office, the tenant is no longer responsible for its physical delivery to the landlord. It is unnecessary to request a return receipt.[10]

Failure to comply

Failure to timely comply with delivery of a written notice of exercise within the period for exercise of the option causes the lease to automatically expire at the end of its original term. To prevent an unintended expiration of a lease, the tenant's broker might prepare and hand the tenant an exercise of option to renew/extend lease form or make one available to the tenant during the period for exercise of the option. [See Form 566]

An exercise of option to renew/extend lease form provides the tenant with the paperwork needed to properly exercise the option. The notice of exercise states the tenant's intent to exercise the renewal/extension option on its terms and conditions, without qualification or equivocation.

Usually, the broker's fee arrangement on the original lease calls for a fee on any extension or renewal. Not only is the exercise by the tenant a benefit for the tenant, the leasing agent benefits by earning a fee. [See **RPI** Form 113]

8 **Hayward Lumber & Investment Co.** v. **Construction Products Corp.** (1953) 117 CA2d 221

9 Bekins Moving & Storage Co., *supra*

10 **Jenkins** v. **Tuneup** Masters (1987) 190 CA3d 1

EXERCISE OF OPTION TO RENEW/EXTEND LEASE

Prepared by: Agent ______________________ Phone ______________________
Broker ______________________ Email ______________________

NOTE: This form is used by a tenant or their agent when they have been given the option to renew or extend their lease on the expiration of its term, to inform the landlord of the tenant's intent to exercise the renewal/extension option on its terms and conditions, without qualification or equivocation.

DATE: ____________, 20_____, at ____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. A lease agreement dated ______________, 20_____, at ______________________________, California,
1.1 entered into by ____, as the Landlord,
1.2 and ____, as the Tenant,
1.3 recorded ______________________, as Instrument No. ____________, in ___________ County, California,
1.4 regarding real estate referred to as ____
____
____
1.5 provides for the renewal or extension of its term, or is subject to an option to renew or extend this lease granted by Landlord and dated ____________, 20_____.

NOTICE TO LANDLORD:

2. Tenant hereby elects to exercise the option to renew or extend the term of this lease following expiration of the current lease term for the additional period and on the conditions stated in the option.

3. Landlord is hereby requested to respond in writing to Tenant regarding any further actions necessary on the part of Tenant to exercise this renewal/extension option, or implement this election to exercise the option, and result in a binding agreement for the additional term.

4. ____
____
____
____
____
____
____

☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ______________, 20_____
Tenant: ______________________________

Signature: ______________________________
Title: ______________________________
Address: ______________________________
____
Phone: ______________________________
Cell: ______________________________
Email: ______________________________

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Form 566

Exercise of Option to Renew/Extend Lease

Continued possession as exercise

A renewal option need not set forth the time period and manner for its exercise. However, clarified steps and dates make the process simple.

Consider a renewal option which is silent as to the time and manner for exercise, simply stating the tenant has the right to renew for three years. The tenant constructs substantial improvements on the property and remains in possession throughout the entire lease term.

The lease term expires without the tenant giving any notice to the landlord of their intent to renew the lease, yet the tenant remains in possession. The tenant then tenders the correct amount of rent as though they had already exercised their renewal option. The landlord refuses the tender of rent.

The landlord serves a notice to quit on the tenant claiming the tenant did not take steps to exercise the option to renew prior to the expiration of the lease and is unlawfully detaining the premises.

Does the tenant's continued possession of the property after the lease expires constitute exercise of the renewal option when delivery of a notice of intent to exercise is not called for in the option?

Yes! When the tenant has a renewal option and the time and manner for exercise is not specified, the tenant's continued possession and timely tender of rent indicates their election to renew.[11]

Waiver of notice to exercise

A tenant is bound by the terms for exercise of the renewal/extension option unless the landlord has, by their conduct, waived the requirements for exercise.[12]

A **waiver** is the relinquishment by the landlord's conduct of a known right, claim or privilege, such as the tenant's delivery of a notice to exercise the option to extend, since they benefit from the right they granted.

For example, a tenant fails to exercise their option to renew the lease as called for in the renewal option since they do not notify the landlord in writing of their intent to renew prior to expiration of the option.

On expiration of the lease, the tenant remains in possession and tenders rent to the landlord at the new rate called for in the option to renew. The landlord accepts the rent.

Later, the landlord serves a 30-day notice to vacate on the tenant. The tenant claims the renewal option has been exercised and the renewed lease bars the landlord's use of the 30-day notice to vacate to terminate possession since the landlord accepted rent called for in the renewal option.

Is the landlord's acceptance of rent when the tenant continued in possession a waiver of the written notice to exercise?

Yes! The landlord's acceptance of rent at the renewal rate after expiration of the lease waived their right to object to the tenant's prior failure to exercise the renewal option as agreed.[13]

Prior acceptance of rent

Now consider a tenant whose long-term lease contains options to extend the lease. The options will expire unless exercised in writing during a two-month period expiring 60 days prior to the expiration of the lease.

11 **ADV Corp**. v. **Wikman** (1986) 178 CA3d 61
12 **Simons** v. **Young** (1979) 93 CA3d 170
13 **Leonhardi-Smith, Inc.** v. **Cameron** (1980) 108 CA3d 42

Prior acceptance of rent, cont'd

The lease agreement is entered into and dated two years prior to the transfer of possession to the tenant (due to construction). The lease term is set to expire on the fifth anniversary of the date of the lease agreement.

Five years pass after the date of the lease agreement. The tenant remains in possession, paying the rent due during the original term of the lease. The tenant then gives the landlord written notice to extend the lease 60 days prior to expiration of five years after the date of possession, not the date of the lease agreement as called for.

The tenant then remains in possession and pays rent at the increased amount called for in the option to extend. The landlord does not object to the notice of intent to exercise the option to extend and continues to accept rent payments.

Later, a new owner becomes the landlord.

The new landlord serves the tenant with a 30-day notice to vacate. The landlord claims the tenant's occupancy under the lease is a periodic month-to-month tenancy which can be terminated at the will of the landlord since the original lease expired without being extended due to the untimely notice to exercise the renewal option.

The tenant claims the prior landlord's acceptance of the tardy notice to exercise the renewal option and the rent called for in the option waived the landlord's right to enforce the conditions for exercise of the option.

Did the tenant exercise their option to extend due to a waiver of the notice requirement by the prior landlord when the landlord accepted rent after the lease expired and failed to object to delivery of the notice of exercise?

Yes! The landlord's prior acceptance of the rent without objection and receipt of the untimely exercise waived the notice requirement for the exercise of the extension option. Thus, the lease and all its terms remained in effect for the period of extension, barring any attempts by the landlord to terminate the tenant's occupancy as a month-to-month tenancy.[14]

No acceptance of rent

For the landlord to avoid waiving the requirement of a timely and unconditional written notice from the tenant to exercise an option to extend, the property manager and landlord cannot accept rent from the holdover tenant. Unless the rent is paid under a newly negotiated lease agreement unrelated to the expired lease, the landlord effectively extends the expiration date of a lease when they accept rent and allow the tenant to remain in possession.

When the holdover tenant refuses to vacate or refuses to accept an offer from the landlord for a new and different tenancy, the landlord may, without further notice, begin an unlawful detainer action to remove the holdover tenant.

14 **Oxford Properties & Finance LTD** v. **Engle** (9th Cir. 1991) 943 F2d 1150

When the tenant neglects to properly exercise the renewal option, the lease term will itself expire without renewal or extension. The property manager may evict the holdover tenant and relet the premises. Here, the lease has expired and no new arrangement for continued occupancy has been agreed to, either in writing or by the landlord's conduct.[15]

Finally, to exercise the lease renewal option, the tenant needs to be in full compliance with all conditions of the lease. Thus, the tenant may not be in default on rent payments or allow any other material breach of the lease to exist at the time they exercise the option.

The payment of rent is an implied condition which needs to be satisfied, in addition to any other material conditions in the lease agreement, before the renewal option may be properly exercised. When the tenant is in default, their right to exercise their option is suspended.[16]

Notice of option's expiration

A leasing agent negotiating a renewal option on behalf of a tenant needs to consider arranging for the inclusion of a notice provision. The provision requires the landlord to give the tenant notice of the option's expiration 60 to 180 days prior to the expiration of the option.

This notice from the landlord to the tenant of the option's expiration eliminates the element of surprise for both landlord and tenant.

The tenant's inadvertent failure to exercise the lease renewal option can prove disastrous for the tenant who plans to continue in occupancy.

If the landlord will re-rent to the existing tenant despite the tenant's failure to exercise a renewal/extension option, the tenant will be forced to negotiate the terms of a new lease under the existing market conditions. Thus, the landlord may be in a position, if availability of space is extremely scarce, to take unconscionable advantage of the tenant, a situation the landlord needs to be careful to avoid.

Renegotiation of rent and lease terms on expiration of a lease can result in increased rental rates, higher common area maintenance fees and other landlord charges. When the landlord chooses to negotiate a lease with the holdover tenant, it may change the tenant's responsibilities.[17]

Thus, a tenant's broker needs to inform the client as to when and how the renewal option has to be exercised, and then provide the tenant with the necessary forms.

The leasing fee due on renewal is sufficient incentive for the broker to take action and assist the buyer to exercise the option.

---

15 Simons, *supra*

16 **Nork** v. **Pacific Coast Medical Enterprises, Inc.** (1977) 73 CA3d 410

17 Bekins Moving & Storage Co., *supra*

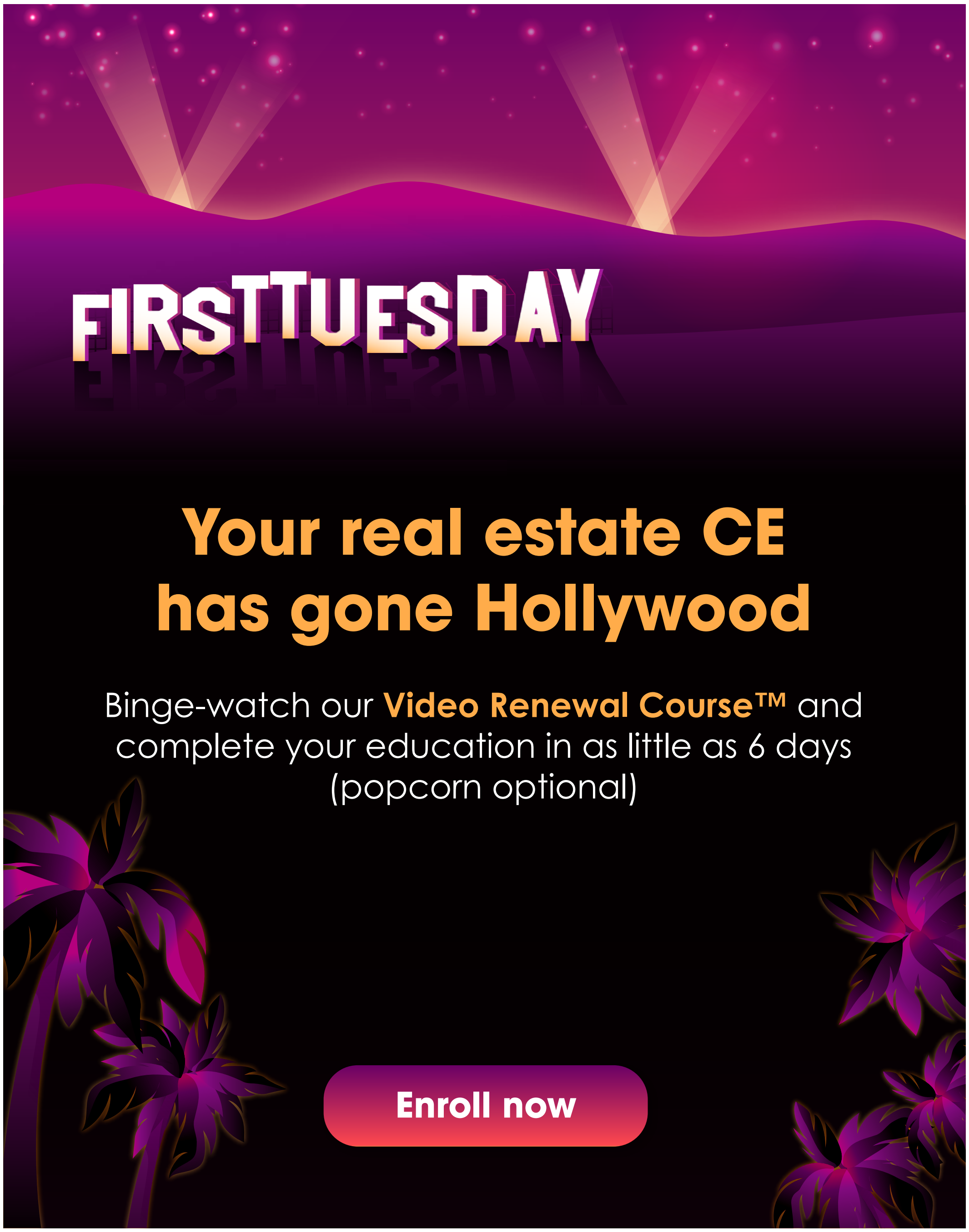
Chapter 27 Summary

Frequently, lease agreements contain provisions or addendums which allow a tenant to continue in lawful possession after the initial lease term expires. A prior agreement allowing continued occupancy is called an Option to Renew/Extend the Lease.

An extension is a modification of the original lease term by extending its expiration date for an additional period. On the other hand, a renewal requires the execution of a new lease on identical conditions to the original lease agreement, not a continuation of the old lease.

A renewal involves the preparation and signing of a new lease which creates an entirely new tenancy. The new tenancy is subject to any change in law affecting the rights and obligations of the landlord or the tenant. It is also subordinate to any encumbrances which occurred during the term of the prior lease.

Chapter 27 Key Terms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Chapter 28

Options and the right of first refusal to buy

Learning Objectives

After reading this chapter, you will be able to:

- identify the various agreements granting a tenant the right to buy;
- differentiate between an option to renew and an option to extend;
- understand how different lease provisions impact the right to buy; and
- advise tenants how to properly exercise their right of first refusal to buy a leased premises.

Key Terms

call option	**option to extend**
option period	**option to renew**
option to buy	**right of first refusal**

Tenants with rights to acquire the premises

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.

option to extend
An agreement granting a tenant the right to extend possession under the original lease agreement on terms set out in the option to extend. [See **RPI** Form 565]

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 **RPI** Form 163]

Option to buy vs. right of first refusal

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**.

option to buy
An agreement granting an irrevocable right to buy property within a specific time period. [See **RPI** Form 161]

right of first refusal
A pre-emptive right to buy a property if the owner decides to sell. [See **RPI** Form 579]

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.

The option agreement

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 **RPI** Form 161]

A tenant enters into a commercial lease agreement. The agreement provides for the tenant to renew the lease, though it does not specify how many times the tenant is able to exercise the option to renew, and includes provisions indicative of a short-term lease. The tenant renews the lease at the end of the first term, then attempts to renew again at the end of the second term which the landlord rejects.

The landlord seeks to terminate the lease, claiming they were not obligated to provide another renewal since the original lease did not explicitly offer an unlimited number of renewals, and the lease was consistent with a traditional, short-term lease, rather than a perpetual lease.

The tenant claims the original lease allows for an unlimited number of renewals since it does not directly state it allows only one lease renewal.

*A California appeals court held the landlord may terminate the lease since unlimited renewals may only be enforced if the lease demonstrates the landlord's intent to offer unlimited renewals, which it did not as the lease included provisions typical of a short-term lease. [**Ginsberg** v. **Gamson** (2012) 205 CA4th 873]*

Case in point

Is an option to renew unlimited?

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.

call option
An agreement giving a buyer the right to buy property within a specified time or upon an event at a specified price with terms for payment. [See **RPI** Form 161]

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]

option period
The specified time period during which the tenant has the right to buy under an option agreement. [See **RPI** 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]

1 **Bekins Moving & Storage Co.** v. **Prudential Insurance Company of America** (1985) 176 CA3d 245

2 **In re Marriage of Joaquin** (1987) 193 CA3d 1529

Form 161

Standard Option to Purchase

Page 1 of 2

NOTICE TO OCCUPANT OF ENTRY AND COMPLETION OF SHOWING
For Residential and Commercial Rentals (Calif. Civil Code §1954(d)(2))

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

NOTE: This form is used by the owner of a rental property listed for sale when with a prospective buyer they have entered and shown the unit based on the 120-day "For Sale" notice previously served on the tenant to advise the tenant the entry occurred and has been completed.

DATE: __________, 20____, at ______________________, California.
Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement
1.1 dated __________, at ______________________, California,
1.2 entered into by ______________________, as the Tenant,
and ______________________, as the Landlord,
1.3 regarding real estate referred as ______________________
______________________.

NOTICE TO TENANT:

2. On __________, 20 ______, you were given notice of Landlord's or their Agent's intent to enter the leased premises you occupy to show the unit to prospective Buyers. [See **RPI** Form 116]

3. You are advised the showing of your unit has been completed by
______________________, as the Agent, or
______________________, as the Landlord.

Date: __________, 20______
Landlord: ______________________
Agent: ______________ CalBRE #: __________

Signature: ______________________
Address: ______________________
____
Phone: ______________ Cell: ______________
Fax: ______________________

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option to renew
An agreement granting a tenant the right to continue in possession upon expiration of the existing lease under a new lease agreement on the same conditions as the expiring lease agreement on terms for payment of rent set out in the option to renew. [See **RPI** Form 565]

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

PAGE 2 OF 2 — FORM 161

9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by ____________________, with an unpaid principal balance of $______________, payable $______________ monthly, including interest not exceeding ______%, ☐ ARM, type ______________________, due ______________, 20______.

9.5 A note for the balance of the purchase price in the amount of $______________ to be executed by Optionee in favor of Optionor and secured by a trust deed on the property junior to the above referenced financing, payable $______________ monthly, or more, beginning one month after closing, including interest at ______% per annum from closing, due ___________ years after closing.

a. This note and trust deed to contain provisions to be provided by Optionor for:
☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐______________________________

b. ☐ The attached Financial Disclosure Statement is an addendum to this agreement (mandatory on four-or-less residential units). [See **RPI** Form 300]

c. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **RPI** Form 412]

10. GENERAL PROVISIONS:

10.1 ☐ **See attached addendum for additional provisions.** [See **RPI** Form 250]

10.2 Attached as addenda are the following checked disclosures mandated on four-or-less residential units:

a. ☐ Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **RPI** Form 304]

b. ☐ Natural Hazard Disclosure Statement [See **RPI** Form 314]

c. ☐ Disclosure of Sexual Predator Database [See **RPI** Form 319]

d. ☐ Hazard Disclosure Booklet, and related Optionor disclosures, containing Environmental Hazards, Lead-based Paint and Earthquake Safety [See **RPI** Forms 313 and 315]

e. ☐ Documentation on any Homeowners' Association (HOA) involved. [See **RPI** Form 309]

f. ☐ Notice of Supplemental Property Tax Bill [See **RPI** Form 317]

10.3 Possession of the property to be delivered on:
☐ close of escrow, or ☐ see attached Occupancy Agreement. [See **RPI** Forms 271 and 272]

10.4 Both parties reserve their rights to assign, and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice.

11. EXPIRATION OF OPTION:

This offer to sell will be deemed expired if not accepted by exercise during the option period.

11.1 This option contract will automatically terminate by expiration on ____________, 20______.

OPTIONOR'S BROKER: ____________	**OPTIONEE'S BROKER:** ____________
Broker's CalBRE #: ____________	Broker's CalBRE #: ____________
Buyer's Agent: ____________	Agent's Name: ____________
Agent's CalBRE #: ____________	Agent's CalBRE #: ____________
Signature: ____________	Signature: ____________
Is the agent of: ☐ Optionor exclusively ☐ Both Optionor and Optionee.	Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: ____________	Address: ____________
Phone: ____________ Cell: ____________	Phone: ____________ Cell: ____________
Email: ____________	Email: ____________
I hereby grant this option and agree to the terms stated above.	**I hereby accept this option and agree to the terms stated above.**
Date: ____________, 20______	Date: ____________, 20______
Optionor: ____________	Optionee: ____________
Signature: ____________	Signature: ____________
Signature: ____________	Signature: ____________
address: ____________	address: ____________
Phone: ____________ Fax: ____________	Phone: ____________ Fax: ____________
Email: ____________	Email: ____________

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Form 161

Standard Option to Purchase

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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]

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;

3 In re Marriage of Joaquin, *supra*

- 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.

Decision to sell triggers option to buy

Consider a buyer who 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 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]

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4 **Rollins** v. **Stokes** (1981) 123 CA3d 701

5 **Estate of Patterson** (1980) 108 CA3d 197

Form 579

Right of First Refusal to Buy

RIGHT OF FIRST REFUSAL TO BUY

Addendum

NOTE: This form is used by a leasing agent or prospective tenant when negotiating a rental or lease agreement, to provide in an addendum the landlord's grant to the tenant of a right of first refusal to purchase the leased premises.

DATE: ____________, 20_____, at ____, California.

TO: ____

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a rental or lease agreement

1.1 ☐ of same date, or dated ____________, 20_____, at ____________________________, California,

1.2 entered into by ____, as the Tenant, and

1.3 ____, as the Landlord,

1.4 regarding the leased premises referred to as ____________________________________

____.

AGREEMENT:

In addition to the terms of the agreement referenced above, Tenant and Landlord agree to the following.

Right of first refusal to buy:

2. Landlord hereby grants Tenant a right of first refusal to purchase the leased premises, for a term commencing ____________, 20_____, and expiring ____________, 20_____, or ☐ on termination of Tenant's right of occupancy.

3. If Landlord decides to sell the premises during the term of Tenant's right of first refusal, Landlord will notify Tenant of the terms on which Landlord is willing to sell. [See **RPI** Form 579-2]

3.1 Tenant has the option, for a period of _____ days after receiving Landlord's written notice sent by certified mail or personal delivery, to agree to purchase the premises on the terms stated in the notice.

3.2 If Tenant fails to exercise the option within the option period, Landlord has the right to sell the premises to a third party on the same terms stated in Landlord's notice to Tenant.

3.3 Any sale on different terms reinstates the Tenant's right of first refusal.

4. If Landlord has not closed a sale of the property within six (6) _____ months after Tenant's receipt of Landlord's notice, Tenant's right of first refusal is reinstated.

5. ____

Tenant	Landlord
Tenant: I agree to the terms stated above.	**Landlord: I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]	☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: ____________, 20_______	Date: ____________, 20_______
Tenant: ______________________	Landlord: ______________________
By: ______________________	By: ______________________
Tenant: ______________________	Landlord: ______________________
By: ______________________	By: ______________________

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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]

Deficient offer constitutes a waiver

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]

Reinstatement of the right of first refusal

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

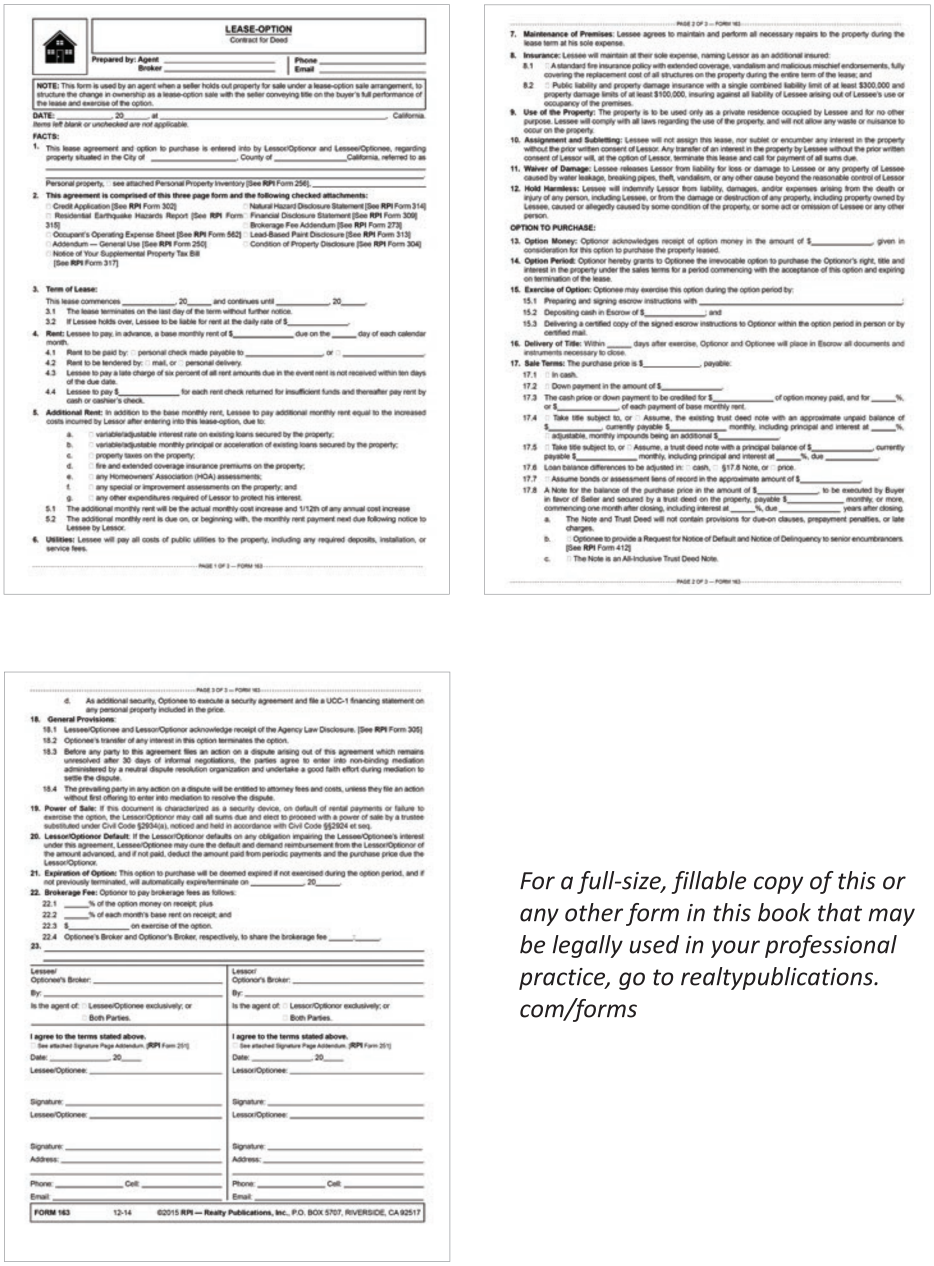
6 **C. Robert Nattress & Associates** v. **CIDCO** (1986) 184 CA3d 55

7 **McCulloch** v. **M & C Beauty Colleges** (1987) 194 CA3d 1338

Figure 1

Form 163

Lease-Option – Contract for Deed



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- 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 tenant chooses not to exercise their option to buy at the price and on the terms offered. The landlord later modifies the listing by lowering the sales price or altering the terms for payment of the price.

The price reduction or modification of terms automatically reinstates the tenant's right of first refusal obligating the landlord to re-notify the tenant of new terms for purchase of the property. The tenant only waived their right of first refusal for a sale based on the terms originally given to them by the landlord, not on the different price or set of terms.

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 28 Summary

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:

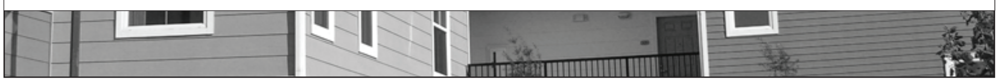
- listing or advertising the property for sale;
- offering the property for sale to a buyer;
- accepting an offer or making a counteroffer involving a sale to a buyer; and
- granting a purchase option.

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.

Chapter 28 Key Terms

Chapter 29

Lease assignments and subleases



Learning Objectives

After reading this chapter, you will be able to:

- apply the standards for a landlord's review of a tenant's request for the landlord's consent to the tenant's transfer of their leasehold interest; and
- identify permissible landlord exactions for their consent to tenant assignments and subletting, the subject of restriction-on-transfer provisions in lease agreements.

Key Terms

assumption

novation

overriding rent

restriction-on-transfer provision

successor tenant

tenant-mitigation provision

transfer

Consent conditioned on exactions

A commercial lease agreement entered into by a tenant contains an assignment and subletting provision, called a **restriction-on-transfer provision** or a *restraint-on-alienation provision*.

The *restriction-on-transfer provision* either prohibits transfer of the tenant's interests or requires the landlord's consent prior to assigning, subletting or further encumbering the tenant's leasehold interest. If the provision permits an assignment or subletting, it states the landlord's consent will not be unreasonably withheld. [See **RPI** Form 552; see Figure 1]

restriction-on-transfer provision
A provision in a lease agreement calling for either the landlord's consent to any transfer of the tenant's leasehold interest or the prohibition of any transfer of that interest. [See **RPI** Form 552 §9.2]

Further, the lease agreement signed by the tenant contains a *cancellation provision*. The cancellation provision allows the landlord to cancel the lease agreement and terminate the tenant's occupancy on the landlord's receipt of the tenant's written request to sublet the premises.

Figure 1

Excerpt from Form 552

Gross — Single Tenant

9. **ASSIGNMENT, SUBLETTING AND ENCUMBRANCE:** [Check only one]
   9.1 ☐ Tenant may not assign this lease or sublet any part of the Premises, or further encumber the leasehold.
   9.2 ☐ Tenant may not transfer any interest in the Premises without the prior consent of Landlord.
      a. ☐ Consent may not be unreasonably withheld.
      b. ☐ Consent is subject to the attached alienation provisions. [See **RPI** Form 552-7]

After taking occupancy, the tenant vacates the premises and relocates their operations to another property. The tenant has no intention of returning to the leased premises.

The tenant finds a new tenant who will pay rent at current market rates for the space. The current market rates exceed the rent owed under the lease agreement. The amount by which the current market rates exceed the rents under the lease is called **overriding rent**.

overriding rent
The amount the current market rent rates exceed the rents set in the lease agreement, attainable by the tenant on a sublease to a successor tenant.

The tenant requests the landlord's consent to sublease to the new tenant. The landlord responds by cancelling the lease agreement and terminating the tenant's leasehold interest under the cancellation provision.

The landlord, having terminated the tenant's leasehold by cancellation of the lease agreement, negotiates directly with the new tenant. The landlord enters into a lease of the premises with the new tenant at current rental rates.

The previous tenant makes a demand on the landlord for the overriding rent they lost due to the landlord's refusal to consent to the sublease, claiming the landlord's consent was unreasonably withheld since no conditions for the consent were agreed to that entitled the landlord to the *overriding rent*.

The landlord claims their cancellation of the lease is valid, even though cancellation is an absolute restraint on the proposed *transfer* of the tenant's leasehold interest. The tenant and landlord bargained for the cancellation provision that was triggered by the tenant's request for the landlord's consent to a sublease.

transfer
Any assignment, sublease or further encumbrance of the leasehold by the tenant. [See **RPI** Form 552 §9]

May the landlord cancel the lease agreement on receipt of the tenant's request for consent to an assignment even though they agreed not to unreasonably withhold their consent?

Yes! The two provisions in the lease, the *consent-to-assignment provision* and the *cancellation provision*, are mutually exclusive alternative remedies. They give the landlord a choice between two different and separate courses of action when confronted with a request for consent to a sublease.

Cancellation nullifies the need to consider request for consent

In the previous example, the landlord exercised the cancellation provision on receipt of the tenant's request for consent. Thus, the tenant is relieved of any further obligation under the lease agreement. Cancellation also terminated the tenant's right of possession and any potential profit between the lease agreement rent rate and the property's appreciated rental value.

Thus, the issue as to whether the landlord refused their consent never arises. The landlord cancelled the lease as agreed, nullifying any need to consider the request for consent.

If the landlord chooses not to cancel the lease agreement and terminate the tenancy on the tenant's request for consent to an assignment, the landlord is then obligated to analyze whether or not to consent. In an analysis, they are required to be reasonable about any objection they may have to the assignment since no other standard was set in the lease.

The cancellation provision in the lease agreement is bargained for and not the unconscionable result of an interference with an assignment of the lease.

Here, the tenant contracted away their leasehold right to retain the benefit of increased rental value of the property by assignment or subleasing when they included the cancellation provision in the lease agreement. The leasehold was eliminated by the cancellation of the lease agreement. With the lease agreement cancelled and the leasehold terminated, the right to assign or sublet did not become an issue. Thus, the landlord did not interfere with the tenant's right to assign or sublet since the leasehold no longer existed to be assigned or sublet.[1]

Transfer of any interest

A *restriction-on-transfer provision* in a lease agreement typically calls for the tenant to acquire consent from the landlord before the tenant may transfer their leasehold interest.[2] [See Form 552-7 accompanying this chapter; see Figure 1 §9.2]

A **transfer** by the tenant includes an assignment, sublease or further encumbrance of the leasehold.[3] [See Figure 1]

An *assignment* of the lease agreement transfers the original tenant's entire interest in the property to a **successor tenant**, leaving no interest held by the original tenant. However, the original tenant named on the lease agreement remains liable for the *successor tenant's* performance on the lease, even though the landlord consents to the assignment and the successor tenant becomes primarily responsible for the lease obligations. The act of taking over a previous tenant's lease agreement and right of possession is called an **assumption**.

assumption
The promise by a successor tenant to fully perform all obligations under the lease agreement they are taking over by assignment from the previous tenant.

For the original tenant to be released of their liability under the lease agreement on an assignment, a **novation** (also known as a substitution of liability) is negotiated and entered into by the landlord and both tenants.[4] [See Form 552-7]

novation
An agreement entered into by a landlord and tenant shifting responsibility for obligations owed the landlord under a lease agreement to another the tenant, releasing the original tenant of liability.

On the other hand, when entering into a *sublease* with a *subtenant*, the original tenant (or *master tenant*) transfers to the subtenant less than all of the master tenant's interest in the property. Also, possession reverts back to the master tenant on expiration of the sublease.

---

1 **Carma Developers, Inc.** v. **Marathon Development California, Inc.** (1992) 2 C4th 342

2 Calif. Civil Code §1995.250

3 CC §1995.020(e)

4 **Samuels** v. **Ottinger** (1915) 169 C 209

The master tenant granting the sublease remains obligated to perform on the *master lease agreement*. The subtenant does not assume liability of the master lease. However, the subtenant may not act in any way that constitutes a breach of the master lease agreement. A copy of the master lease agreement is provided to the subtenant as an attachment to the sublease. [See **RPI** Form 552 §2.5]

The *further encumbrance* of a tenant's leasehold interest is a transfer and occurs when the tenant places a lien on their leasehold to secure a mortgage, such as a trust deed or a collateral assignment.

Editor's note — For simplicity's sake, the following discussion will only refer to an assignment of a lease. However, the discussion fully applies to transfers by any sublease or further encumbrance transaction.

Various alienation provisions

Leases include various types of *restriction-on-transfer provisions*, which may:

- entirely prohibit any assignment of the tenant's leasehold interest[5];
- require the landlord's consent prior to an assignment without referencing *approval standards* or placing any *monetary conditions* on the tenant for obtaining the landlord's consent, called **exactions**[6];
- require the landlord's consent prior to an assignment, stating consent will not be unreasonably withheld[7];
- require the landlord's consent, subject to conditions first being met by the tenant[8]; or
- contain conditions for a valid assignment without requiring any consent from the landlord.[9] [See Figure 1]

Approval standards lay out the analytical process to be applied by the landlord when judging whether or not to withhold consent.

Monetary conditions are sums of money or modified leasing terms to be met by the tenant as a pre-requisite to the landlord's consent.

No standards for withholding consent

Consider a lease agreement with a *restriction-on-transfer provision* calling for the landlord's consent prior to the tenant's assignment. However, the lease does not contain any standard or condition for the landlord's consent.

Here, for lack of agreement to the contrary, the standards and conditions for the landlord's consent are set by law.

5 CC §1995.230
6 CC §1995.260
7 CC 1995.250(a)
8 CC §1995.250(b)
9 CC §1995.240

Any lease agreement entered into without stating a standard for the landlord's consent to an assignment, requires the landlord to have a commercially reasonable basis for any denial of consent. The landlord cannot arbitrarily deny consent.

Also, the landlord may not impose conditions on the consent, such as a higher rent rate, unless the condition was included in the lease agreement.[10]

Commercial reasonability standards

Commercial reasonability standards relate to the landlord's ability to:

- protect their ownership interest from property waste and financial deterioration caused by the conduct of the *successor tenant*; and
- ensure the future performance of the lease by an assignment to a creditworthy tenant.

successor tenant
On a transfer, the new tenant who acquires by assignment the original tenant's entire leasehold interest in the property. [See **RPI** Form 552 §9]

Commercially reasonable objections for withholding consent to an assignment include:

- the successor tenant's financial responsibility, net worth, prior operating history and creditworthiness;
- the successor tenant's intended use, care and maintenance of the property;
- the suitability of the successor tenant's use, product marketing and management style for the property; and
- the need for tenant alterations to the premises.[11]

For example, the *use provision* in a lease agreement gives the tenant the right to operate their service business in a landlord's shopping center. The landlord also runs a retail business outlet in the same shopping center. The lease agreement restricts the tenant's use to an "office use related to the business" of the tenant.

The restriction-on-transfer provision in the lease agreement requires the tenant to obtain the landlord's prior consent to an assignment of the lease agreement. The provision sets no standard for withholding consent and provides for no conditions to be met (paid/lease modification) by the tenant for the consent.

Later, the tenant seeks to transfer the lease to a successor who will operate a retail business from the premises. The successor tenant's retail business will be in direct competition with the landlord's retail outlet. Since the successor tenant's use will be a change in the use of the premises, the landlord refuses to consent to the assignment.

The tenant claims the landlord's refusal is commercially unreasonable since it amounts to economic protectionism unrelated to the landlord's ownership and operation of the rental property.

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10 **Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488

11 Kendall, *supra*

Here, the landlord's refusal is a commercially reasonable application of the use restriction in the lease agreement. The landlord sought only to retain the use originally intended by the lease. The refusal is not due to improper economic protectionism in the management and operation of the real estate since the landlord did not demand an *exaction* through an increase in rent or other economic benefits to enhance themselves as a condition for their consent to the assignment of the lease.[12]

Also, the landlord may reasonably refuse their consent to a trust deed lien the tenant seeks to place on the leasehold interest when the proceeds of the mortgage are not used to enhance or improve the property.[13]

Reasonable increases in rent

Consider a commercial tenant who agrees to a *percentage lease*. [See **RPI** Form 552-4; see Chapter 25]

The restriction-on-transfer provision in the lease agreement requires the tenant to obtain the landlord's consent before assigning the lease. The provision does not include standards or conditions for the landlord's consent to an assignment.

The tenant enters into an agreement to sell their business and assign the lease to a new operator. The operator buying the tenant's leasehold interest (and the business) is to pay the tenant the *overriding rent* over the remaining life of the lease.

The tenant requests consent for the assignment of the lease agreement from the landlord. On investigation, the landlord determines the operator will manage the business in a manner that will not generate gross sales at the same level as the current tenant. Thus, under the percentage lease, the new operator will not become obligated to pay the amount of rent currently being paid by the tenant seeking consent.

However, the landlord agrees to consent to the assignment conditioned on the landlord receiving the overriding rent premium the tenant is to be paid for the assignment.

The tenant claims the landlord cannot condition consent on exacting the rent premium since no standards or conditions for consent exist in the lease and thus cannot now be imposed.

Here, the landlord's conditional consent to the assignment is commercially reasonable. When granting consent, the landlord is entitled to preserve the rental income they currently receive from the existing tenant. The landlord does not need to accept the certain risk of a lower monthly percentage rent from the assignee while the original tenant receives a monthly premium.[14]

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12 **Pay 'N Pak Stores, Inc.** v. **Superior Court of Santa Clara County** (1989) 210 CA3d 1404

13 **Airport Plaza, Inc.** v. **Blanchard** (1987) 188 CA3d 1594

14 **John Hogan Enterprises, Inc.** v. **Kellogg** (1986) 187 CA3d 589

Proceeds from assignment demanded

Now consider a commercial lease agreement that contains a restriction-on-transfer provision authorizing the landlord to demand all the consideration the tenant will receive for an assignment of the lease as a condition for their consent to the assignment.

The landlord does not bargain for any other exaction, such as key money, lease assignment-assumption fee or a portion of the purchase price the tenant will receive on a sale of the business that the tenant operates from the premises.

Later, the tenant agrees to assign the lease to a new operator as part of the sale of their business. The operator will pay the tenant a lump sum for the lease as part of the purchase price since rent due under the lease agreement is below market rates.

The landlord demands the tenant pass on to the landlord the price received for assignment of the lease as a condition for their consent to the assignment. The tenant rejects this demand.

The tenant claims the landlord's demand in exchange for consent is commercially unreasonable, and thus unenforceable, since the landlord has no lawful justification for the premium or additional rent.

Here, the landlord may condition consent on their receipt of the payment made for the assignment of the lease. Commercial lease agreements granting the landlord the right to receive any consideration the tenant is to receive related (and limited) to the value of the lease to be assigned are enforceable.[15]

Absent unconscionable or discriminatory provisions, commercial landlords and tenants are free to place commercially reasonable restrictions — limited to the value of the leasehold, not any part of the price the tenant received on the sale of the business — on any assignment of the lease.[16]

More than rental value demanded

Again, it is commercially reasonable for a commercial lease agreement to provide for the landlord to receive all consideration the tenant receives for the assignment of the lease in exchange for the landlord's consent.[17]

However, the consideration the landlord may receive for their consent to an assignment is limited to financial benefits related to the value of the lease assigned.

For example, a tenant occupies commercial property under a lease agreement.

The lease agreement includes a *profit-shifting clause* calling for the tenant to pay the landlord 25% of the consideration the tenant receives for *business goodwill* on the sale of the tenant's business, in exchange for the landlord's consent to an assignment.

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15 CC §1995.240

16 Carma Developers, Inc., *supra*

17 CC §1995.240

Both agree it is the location of the leased property which will give the tenant's business its goodwill value.

The tenant's business is a success and the tenant locates a buyer for the business and the remaining term on the lease. The tenant seeks the landlord's consent for an assignment of the lease.

As agreed, the landlord demands 25% of the consideration the tenant will receive for their business goodwill. The tenant refuses to meet the demand and the landlord refuses to consent to the assignment.

As a result, the sales transaction does not close. The tenant makes a demand on the landlord for 100% of their lost profits on the sale.

The tenant claims the landlord's demand for a share of the profits on the sale of the business as agreed to in the lease agreement was a commercially unreasonable and unenforceable condition for granting consent to the assignment.

The landlord claims the profit-shifting provision is enforceable since all consideration received by the tenant on a transfer of the lease, even in excess of the value of the lease, may be agreed to and taken in exchange for consent.

Here, the landlord's right to receive consideration in exchange for their consent to an assignment is limited to the consideration the tenant receives for the value of the lease.[18]

Unconscionable advantage situations

Now consider a subtenant who needs to negotiate a new lease with the landlord or be evicted. The master tenant's lease agreement has been terminated by the landlord due to no fault of the subtenant.

The landlord submits a proposed lease agreement to the subtenant which differs significantly in its terms and conditions from the wiped out sublease agreement the subtenant held with the master tenant. When the subtenant attempts to negotiate a reasonable rent and eliminate unacceptable provisions, the landlord tells the subtenant to "take it or leave it." The subtenant is told they will be evicted if the proposed lease agreement is not signed.

The proposed lease agreement includes a restriction-on-transfer provision calling for a 200% increase in rent as a condition to be met before the landlord will consent to an assignment of the lease.

The subtenant signs the lease. Later, the subtenant seeks the landlord's consent to an assignment of the lease on sale of their business. The landlord demands a modification of the rent provision to reflect the 200% increase in monthly rent as agreed, which the subtenant's buyer refuses to sign.

The tenant claims the provision was the result of an **unconscionable advantage** held as a negotiating advantage by the landlord. When the lease

18 **Ilkhchooyi** v. **Best** (1995) 37 CA4th 395

was negotiated, the tenant could not refuse to rent due to the goodwill they had built up for their business through a heavy investment in advertising at the location.

The landlord claims the restriction-on-transfer provision is enforceable since the clause was freely bargained for.

Can the tenant avoid enforcement of the restriction-on-transfer provision?

Yes! The restriction-on-transfer provision agreed to was the result of the landlord taking *unconscionable advantage* of the subtenant's adverse situation. The subtenant was in possession under a wiped out sublease without any power to freely bargain. The subtenant was already in possession and operating a business that had developed goodwill that will be lost if they vacate.

Unconscionable and unenforceable

Collection of future rents so hugely excessive as to effectively shift profits from the sale of the business to the landlord for their consent to an assignment of a lease was overreaching on the landlord's part. Thus, the restriction-on-transfer provision was unenforceable as the product of the unconscionable advantage taken by the landlord.[19]

Also, any consideration the landlord seeks which is beyond the value of the leasehold interest or the landlord's interest in the real estate is not reasonable, whenever or however bargained for. The right to freely bargain is not intended to give the landlord the right to freely fleece a tenant of the tenant's assets beyond the lease in the name of freedom of contract.[20]

Tenant-mitigation provisions

When a commercial lease agreement contains a **tenant-mitigation provision** and the tenant breaches the lease, the landlord may leave the lease in place and recover rent for the life of the lease. [See **RPI** Form 552 §21.1; see Figure 2]

Under a *tenant-mitigation provision*, the breaching tenant who has vacated the property has the duty to:

- find a replacement tenant;
- pay for any tenant improvements (TIs); and
- collect rent.[21]

In other words, the tenant-mitigation provisions shifts to the tenant the responsibility of mitigating the landlord's losses for the tenant's breach.

However, if the lease agreement also provides for the landlord's prior consent to an assignment of the tenant's leasehold interest, the tenant-mitigation provision is enforceable only if the landlord's consent to an assignment is not unreasonably withheld.[22]

tenant-mitigation provision
A provision in a commercial lease agreement allowing the landlord to leave the tenant's leasehold and the lease agreement intact on the tenant's breach, and then recover rent from the tenant for the life of the lease without the landlord first taking steps to mitigate losses. [See **RPI** Form 552 §21.1]

19 Ilkhchooyi, *supra*
20 Ilkhchooyi, *supra*
21 CC §1951.4
22 CC §1951.4(b)(3)

Figure 2

Excerpt from Form 552

Gross — Single Tenant

21. DEFAULT REMEDIES:

21.1 If Tenant breaches any provision of this lease agreement, Landlord may exercise its rights, including the right to collect future rental losses after forfeiture of possession.

A landlord who prohibits assignments or unreasonably withholds consent retains the duty to mitigate their loss of rents on the tenant's breach.

Broker's role in assigning or subletting

Restriction-on-transfer provisions become a concern of the business-opportunity (bus-op) or industrial leasing agent when:

- negotiating the assignment of a lease in a bus-op sale (or negotiating a sublease or a further encumbrance);
- relocating a tenant whose current lease has not yet expired; or
- negotiating the origination of any lease.

A broker handling a bus-op sale or relocation of a business or industrial tenant needs to determine the tenant's ability to assign the existing lease to a potential buyer or other successor tenant.

The broker starts the analysis by ascertaining the type of restriction-on-transfer provision the lease agreement contains. The broker can then determine the tenant's assignment rights.

Now consider a leasing agent who is negotiating a lease on behalf of a prospective tenant. The tenant's agent limits the wording of a restriction-on-transfer provision to include:

- the landlord's consent "will not be unreasonably withheld"; and
- any exaction to be paid for the consent is limited to the consideration the tenant receives for the rental value of the premises.

Here, a prohibition against assignment is eliminated by including the "with consent" provision.

Compensation for consent

Conversely, the landlord's leasing agent reviews the restriction-on-transfer provision and suggests the tenant pay compensation to the landlord in exchange for any consent to a transfer. For example, in exchange for consent, the landlord may:

- adjust rents to current market rates;
- receive fees and costs incurred to investigate the successor tenant's credit;
- receive any *overriding rent* or lump sum payment the tenant receives that is attributable to the value of the lease;

Form 552-7

Commercial Lease Agreement Addendum — Alienation of Leasehold

COMMERCIAL LEASE AGREEMENT ADDENDUM

Alienation of Leasehold

NOTE: This form is used by a leasing agent or landlord as an addendum when the landlord negotiating a commercial lease is concerned about the tenant selling their business or their leasehold to another operator, to include provisions in an addendum to a lease agreement requiring the landlord's consent for the tenant to assign, sublet or further encumber their leasehold interest in the property.

DATE: _____________, 20______, at ____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a commercial lease agreement

1.1 dated _____________, 20_____, at ____, California,

1.2 entered into by ____, as the Landlord,

1.3 and ____, as the Tenant,

regarding real estate referred to as ____

____.

ALIENATION OF LEASEHOLD:

2. Any transfer by Tenant of any leasehold interest held by Tenant, voluntarily or involuntary, is a breach of this lease unless Tenant has requested and received Landlord's prior written consent, which will not be unreasonably withheld.

3. The transfer of 50% or more, cumulative, of the ownership of Tenant constitutes a transfer requiring Landlord's prior consent.

4. Upon Tenant's request for Landlord's consent to an assignment or subletting, Tenant needs to notify Landlord in writing and provide Landlord with:

a. the name and address of the proposed assignee or subtenant;

b. the nature and character of the business of the proposed assignee or subtenant;

c. current financial statements for the proposed assignee or subtenant prepared in accordance with generally accepted accounting principles; and

d. the proposed sublet or assignment agreement.

5. Tenant's transfer by assignment to include a written assumption in favor of Landlord by the assignee of Tenant's obligations under the lease.

6. Tenant may assign or sublet the premises to any entity controlling Tenant, controlled by Tenant or under common control with Tenant or affiliated with Tenant, without the prior written consent of Landlord.

7. Tenant licensing of a minimal portion of the premises (i.e., 20 square feet or less) to be used by a third-party vendor in connection with the installation of a vending machine, payphone or like equipment does not constitute the transfer of an interest held by Tenant.

8. On an unconsented transfer of any interest held by Tenant under this lease, Landlord may terminate the leasehold interest held by Tenant on a 30-day notice.

9. If Landlord approves an assignment or subletting, Tenant to pay Landlord, as additional rent, fifty percent (50%) of the difference, if any, between:

a. the rent due landlord under this lease agreement; and

b. the rent received by Tenant under the assignment or sublease consented to by Landlord, after deducting costs of customary real estate fees, tenant improvement cost or allowance and reasonable attorney's fees, if any, incurred by Tenant in connection with the assignment or sublease.

10. Tenant is to pay Landlord an administration fee of Five Hundred Dollars ($500.00) per transaction, for Landlord's review and processing of documents regarding any proposed assignment, sublease, or further encumbrance.

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**RPI** Form 251]	☐ See attached Signature Page Addendum. [**RPI** Form 251]
Date: _____________, 20_____	Date: _____________, 20_____
Landlord: ______________________	Tenant: ______________________
Signature: ______________________	Signature: ______________________
	Tenant: ______________________

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- require the successor tenant to pay operating expenses as additional rent such as maintenance, utilities, insurance and taxes; or
- alter the terms of the lease agreement and any options to extend/renew the lease or buy the property.

To be enforceable, any exactions the landlord may expect or later seek for their consent will be:

- agreed to and set forth in the lease agreement; and
- related solely to the value of the lease.

Brokerage fee addendum

A broker employed by a landlord under an *exclusive authorization to lease property* is due a fee if the premises is rented to a tenant located by anyone during the listing period. [See Form 110 in Chapter 12]

Likewise, a broker employed by a tenant under an *exclusive authorization to locate space* is entitled to a fee when the tenant rents space sought by the employment during the listing period. If the tenant rents and does not provide for the landlord to pay the fee, the tenant will owe the broker the fee. [See Form 111 in Chapter 13]

However, brokers too often fail to insist on a written fee agreement from either the landlord or the tenant before rendering services. To be assured a fee when a prior written fee agreement does not exist, the broker includes a fee provision as part of an *offer to lease* or *letter of intent*. The fee is also included as an addendum to the proposed rental or lease agreement. [See **RPI** Form 273]

Chapter 29 Summary

A transfer by the tenant of their leasehold interest in property includes an assignment, sublease or further encumbrance.

The restriction-on-transfer provision may either prohibit transfer of the tenant's interests or it may require the tenant to obtain landlord consent prior to assigning, subletting or further encumbering the tenant's leasehold interest.

The cancellation provision allows the landlord to cancel the lease agreement and terminate the tenant's occupancy on specified events, such as the receipt of the tenant's written request to assign the lease or sublet the premises.

The consent-to-assignment provision and the cancellation provision are mutually exclusive alternatives available to the landlord. They give the landlord a choice between two different and separate courses of action when confronted with a request for consent to an assignment or sublease.

Chapter 29 Key Terms

Chapter 30

Commercial rent control prohibited

Learning Objectives

After reading this chapter, you will be able to:

- work within the limitations of local rent control; and
- explain the differences between permitted residential rent control and the policy against commercial rent control.

Key Term

impasse notice

Legislative purpose

Residential landlords and apartment builders in California have battled **local rent control ordinances** since the mid-1970s.

Some judicial support for de-control is taking root since the societal objectives underlying the enactment of rent control ordinances are not being met.[1]

Further, the California legislature enacted a scheme which will gradually lead to a phaseout of all *residential rent control*. The economics of rent control in the long term are not kind to tenants or the surrounding neighborhoods, while investment capital is unharmed since it simply locates elsewhere.[2]

Most major metropolitan areas in California, including Los Angeles, San Francisco, Oakland and San Jose, have some form of residential rent control. San Diego County and Orange County do not.

However, the city of Berkeley went beyond attempts to control only residential income properties. The city passed rent control ordinances placing restrictions on the amount of rent landlords of commercial properties are able to change.

1 **152 Valparaiso Associates** v. **City of Cotati** (1997) 56 CA4th 378

2 Calif. Civil Code §1954.52

The stated objective supporting the Berkeley commercial rent ordinances was to preserve the city's older business neighborhoods without change or evolvement. Inefficient owners with improperly located shops in high traffic locations saw their rents rise dramatically as their space was sought by better capitalized and more effective businessmen, a process loosely called **Economic Darwinism** or **creative destruction**. Simply put, the landlords were willing to rent to more efficient and productive businesses which pay higher rent.

Local historical preservation advocates asserted rent control was the only way to protect "mom-and-pop" shops, which otherwise are no longer financially viable operations. Conversely, landlords felt they needed to be allowed to rent the space to any tenant whose business operation conforms to existing zoning ordinances.

Local community leadership is caught politically between making a policy commitment to protect inefficient, small shop owners in historic business districts or fostering an environment that encourages the growth of existing businesses or their replacement by fresh, energetic businesses in the same or newly constructed structures.

No commercial rent control ordinances

However, no California city, county or other public agency may pass and enforce *commercial rent control ordinances*.[3]

The California legislature felt commercial rent control was economically improper since it:

- discouraged commercial development and open market competition;
- benefitted one business enterprise over another; and
- hampered business expansion.[4]

Rental limit ban

The ban on commercial rent control also covers actions by all public entities who act as landlords, as well as private landlords.[5]

A public entity includes the state and all:

- cities and counties;
- public authorities and agencies; and
- political subdivisions and public corporations.[6]

Thus, no public entity may control or limit commercial rental rates, directly as owners or indirectly by ordinances. Using the power of **eminent domain** to control rents is improper.

Commercial real estate includes all real estate except:

- dwelling units;

3 CC §1954.25
4 CC §1954.25
5 CC §1954.27(a)
6 Calif. Government Code §811.2

- residential hotels; and
- mobilehome parks.[7]

Thus, the marketplace of available space for rent is left to sort out who will occupy the space in our growth economy without unnecessary government interference.[8]

To meet these ends, public agencies are prohibited from designating a specific tenant with whom a landlord needs to negotiate to create, extend or renew a commercial lease. Any tenant may rent any commercial space based on negotiations unfettered by governmental imposition of rent conditions.[9]

The prohibition against commercial rent control covers all actions by local governments, whether by charter, ordinance, resolution, administrative regulations or policy statements.[10]

Local rent control ordinances cannot establish or dictate any of the terms which might be negotiated in a commercial lease agreement or in the renewal or extension of the lease.

However, not all local government powers have been curbed. What has ended is government interference with commercial lease negotiations between landlords and tenants.

Remaining local powers

Local governments may still regulate all facets of business location and development such as:

- exercising eminent domain powers;[11]
- abating nuisances;[12]
- establishing zoning (use) and business licenses (policing);[13] and
- protecting historical resources.[14]

Also, the ban on commercial rent control does not apply to redevelopment contracts entered into by a developer and a public agency.

Under redevelopment agreements, the developer rents to local businesses at a set or reduced rate in exchange for participation with the public agency.[15]

Negotiations by notice to landlords

Public agencies may establish a notice procedure for an existing commercial tenant to make or solicit an offer to the landlord negotiating for a renewal or extension of the lease.

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7 CC §1954.26(d)
8 CC §1954.27(a)
9 CC §1954.27(a)
10 CC §1954.27(a)
11 CC §1954.28(a)
12 CC §1954.28(b)
13 CC §1954.29(a)
14 CC §1954.28(e)
15 CC §1954.28(d)

However, the agency's action may not interfere with rights held under an existing lease agreement. Thus, they cannot alter the lease expiration date or the attendant obligation of the tenant to vacate on expiration or be evicted.[16]

For example, a lease agreement exists which does not grant an option to the tenant to renew or extend the term of the lease, called a *term-only lease*.

However, the local governing agency may by ordinance create a procedure allowing the tenant to deliver a **negotiation notice** to the landlord. In the negotiation notice, the tenant makes or solicits an offer to negotiate an extension of the term of the lease.[17]

A tenant who has materially breached a significant provision in the lease agreement is not eligible to use the negotiation notice scheme.[18]

The negotiation notice acts as the tenant's offer to acquire an extension or renewal of the lease, an activity a tenant can carry out without the existence of an enabling ordinance. Of course, the tenant does not need to use a negotiation notice to contact their landlord.[19]

On the landlord's receipt of the negotiation notice, the landlord is required to respond if the notice is sent within 270 days before the expiration of the lease.[20]

However, whether or not the landlord receives a negotiation notice from the tenant, the landlord and the property manager have no duty to notify the tenant the lease is expiring at the end of the term stated in the lease agreement.

Impasse notice to tenant

impasse notice
A notice advising the tenant the lease will expire and no modification of the lease will be entered into.

If the tenant delivers the negotiation notice within 270 days before the lease expires, the landlord either:

- enters into negotiations to renew or extend the lease with the tenant; or
- delivers an **impasse notice** to the tenant no more than 180 days before the lease expires, within a time period after receipt of the negotiation notice as set by the local agency.[21]

An *impasse notice* advises the tenant the lease will expire as called for in the lease agreement and no modification of the lease will occur.[22]

For example, a city passes an ordinance requiring a landlord to respond with an impasse notice within 30 days of receiving a negotiation notice, but not prior to 180 days before the lease expires.

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16 CC §1954.31
17 CC §1954.31(a)(1)
18 §1954.31(b)(1)
19 CC §1954.26(j)(2)
20 CC §1954.31(a)(2)(A)
21 CC §1954.31(a)(2)(B)
22 CC §1954.26(i)

However, if the negotiation notice is received 150 days prior to expiration of the lease, the landlord needs to respond within 30 days or they will be acting in bad faith.

The landlord is also required to send an impasse notice when they (or their agent) have received a negotiation notice and entered into renewal or extension negotiations with the tenant which are later broken off. The impasse notice indicates the lease will not be renewed or extended.

Also, negotiation and impasse notice ordinances cannot force the landlord to deal with a tenant or to make a counteroffer to the tenant. A landlord is not required to negotiate an additional or new term with the existing tenant and may reject the tenant's offer by use of the impasse notice.

Time to negotiate

One purpose served by the tenant's notice to the landlord is to allow the tenant time to negotiate a new or extended lease or find alternative space before the lease term expires. In practice, tenants have always knowingly borne these burdens as their possessory interest draws to an end.

Without conjecture as to unintended consequences, these ordinances appear to add nothing to the leasing environment except for the landlord's written impasse notice in response to a prior written offer from the tenant to negotiate.

However, the notice rules do not provide guidance for landlords who commence negotiations which become prolonged and continue beyond the response period set by ordinances for delivery of an impasse notice. If the landlord breaks off negotiations after the response period for delivery of the impasse notice has passed, it is too late to deliver an impasse notice unless the ordinance extended the time in which to respond.

The safest conduct for the landlord who receives a tenant's negotiation notice is to deliver an impasse notice within the response period set by the local ordinance, and then enter into negotiations. If negotiations result in an extension or renewal, the notice becomes irrelevant. If negotiations fail, the landlord complied with the negotiation/impasse ordinance.

Failure to deliver notices

A landlord or property manager who fails to deliver an impasse notice and does not enter into negotiations after the timely receipt of the tenant's negotiation notice may have acted in **bad faith**. A non-response subjects the landlord or property manager to liability for the tenant's actual money losses incurred due to the bad faith failure to deliver the impasse notice.[23]

When confronted with a *bad faith* claim, the landlord needs to immediately deliver an impasse notice and extend the expiration of the lease to a date after delivery of the impasse notice. This conduct provides the tenant with the period of time the tenant was to have prior to expiration of the lease had an impasse notice been timely delivered. The extension avoids loss of the tenant's reasonable expectations, induced by the notice ordinance, of up to a 180-day period to relocate after receipt of an impasse notice.

23 CC §1954.31(a)(3)

Chapter 30 Summary

No California city, county or other public agency may pass and enforce commercial rent control ordinances.

Public agencies are prohibited from designating a specific tenant with whom a landlord needs to negotiate to create, extend or renew a commercial lease. Any tenant may rent any commercial space based on negotiations unfettered by local rent control ordinances.

Public agencies may establish a notice procedure for an existing commercial tenant to make or solicit an offer to the landlord negotiating for a renewal or extension of the lease.

However, the agency's action may not interfere with rights held under an existing lease agreement. Thus, they cannot alter the lease expiration date or the attendant obligation of the tenant to vacate on expiration or be evicted.

Chapter 30 Key Term

Chapter 31

Attornment clauses in commercial leases

Learning Objectives

After reading this chapter, you will be able to:

- identify the mortgage lender's use of attornment, lender subordination, future subordination and nondisturbance clauses in commercial lease agreements; and
- properly apply the use of provisions as a landlord or lender to alter the priorities of leaseholds and trust deed liens.

Key Terms

attornment clause	**nondisturbance clause**
future subordination clause	**nondisturbance agreement**
lender subordination clause	

Altering priorities for lenders

Consider a mortgage lender who holds a recorded trust deed lien on the fee interest in a parcel of commercial income-producing real estate. The trust deed contains a *due-on clause* that states the landlord may not sell, lease or encumber the secured property without the prior written consent of the lender.

The lender has advised the landlord it will consent to new leases under the due-on clause, provided the lease agreements contain an **attornment clause** and a **lender subordination clause**. [See **RPI** Form 552-8]

A tenant later enters into a lease agreement with the landlord that contains an *attornment clause*. The lease agreement is approved by the lender.

The attornment clause in application

The *attornment clause* states the tenant will:

- recognize the buyer who purchases the property at a foreclosure sale on a trust deed of record as the new landlord under the tenant's lease agreement entered into with the current landlord; IF
- the buyer exercises their right to restore the leasehold interest and enforce the lease agreement as the substitute landlord. [See Figure 1; see **RPI** Form 552-8 §3]

Later, the landlord defaults on the lender's trust deed. The lender notices a foreclosure sale and acquires the property.

On taking title to the property, the lender mails a written notice to the tenant stating:

- the lender is the new landlord under the lease agreement; and
- the tenant is to pay rent to the lender.

The tenant does not pay rent and vacates the premises.

The lender claims the tenant is required to accept the lender as the new landlord under the attornment clause in the tenant's lease agreement with the prior landlord.

The tenant claims the attornment clause is unenforceable since the lease agreement that contained the clause was junior to the lender's trust deed and was eliminated by the lender's foreclosure sale.

Is the tenant required to accept the lender as the new landlord and perform under the lease?

Yes! The lease agreement is a contract and remains enforceable after the foreclosure sale. Further, the real property leasehold interest held by the tenant was eliminated from title by the foreclosure sale. However, on notice from the lender that the lender is enforcing the lease agreement under its attornment clause, the tenant is bound to recognize the lender as the substitute landlord.

Since the lender purchased the property at the foreclosure sale and declared itself to be the landlord under the lease agreement, the tenant now pays rent to the substitute landlord and abides by the lease agreement.

Restored and reattached

By the lender's (or other purchaser's) notice to be the substitute landlord by their exercise of the attornment clause, the leasehold interest under the lease agreement is restored and reattached to title.[1]

The attornment clause contracts around the permanent elimination of a tenant's junior leasehold interest on completion of a foreclosure sale by a senior trust deed lender. The clause allows the purchaser at the lender's foreclosure sale to restore the extinguished leasehold as though it was unaffected by the foreclosure sale.

1 **Miscione** v. **Barton Development Company** (1997) 52 CA4th 1320

Figure 1

Excerpt from Form 552-8

Lender Subordination and Attornment Provisions

3. **Attornment clause:** In the event Tenant's estate is exhausted by an elimination of Landlord's estate, Tenant will recognize the new owner who acquires Landlord's estate as Landlord under this Lease should the new owner, within 30 days of acquisition, notify Tenant in writing of the new owner's election to be substituted as Landlord under this Lease.

Priority on foreclosure

A tenant's leasehold interest, whether or not the lease agreement granting the property interest is recorded, has priority on title over an interest in the property held by another person when:

- the lease agreement is recorded before the other interest is recorded or, if unrecorded, is actually known to the person holding the other interest[2]; or
- the tenant takes possession before the other interest is recorded or the tenant's right of possession is actually known to the person holding the other interest.[3]

For example, a trust deed is recorded junior in time to a tenant's occupancy of the secured real estate. The trust deed is foreclosed. The tenant's lease, being prior in time, is undisturbed by the foreclosure — the tenancy established by the lease agreement remains in full effect.

Thus, the buyer at the foreclosure sale of a junior trust deed acquires title "subject to" the lease. Since the leasehold right of possession held by the tenant has priority, the buyer will perform the landlord's obligations under the lease agreement.

Tenant's leasehold interest is junior in time

Now consider a leasehold interest acquired by a tenant under a lease agreement entered into after a trust deed or judgment lien is recorded on the property. Later, the trust deed or judgment lien is foreclosed.

Here, the tenant's leasehold is wiped out by the foreclosure of the trust deed lien or judgment lien. The tenant's leasehold interest in title is junior in time and subordinate to the lien. Again, the lease agreement remains intact as a contract.

On elimination of a junior leasehold by a foreclosure sale of the premises under a lien with priority, the tenant loses their leasehold interest, the right to possession of the premises.[4]

After foreclosure by the senior lienholder, the tenant's continued use and possession of the property is an *unlawful detainer (UD)* and the tenant can be evicted. A three-day notice to quit due to foreclosure is served. On expiration of the notice, a UD action may be filed and the occupant evicted. [See **RPI** Form 578]

2 Calif. Civil Code §1214

3 **Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356

4 **Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605

Editor's note — Different rules apply to a residential rental property sold in foreclosure. The new landlord serves the tenant with a 90-day notice to vacate to terminate a prior month-to-month tenancy, but not a prior lease agreement with more than 90 days remaining. When the buyer intends to occupy the residential property as their primary residence, the 90-day notice terminates the tenant's right to occupancy after foreclosure.

Altering the priorities

Consider a commercial tenant who enters into a lease agreement with a provision permitting the mortgage lender to unilaterally alter the priority of the tenant's leasehold and the lender's trust deed liens on the property.[5]

Commercial lease agreements often contain boilerplate provisions relating to the priority of the leasehold against trust deeds, present and future. These provisions include:

- *attornment clauses* [See Figure 1; see **RPI** Form 552-8 §3];
- *lender subordination clauses* [See Figure 2; see **RPI** Form 552-8 §2];
- *future subordination clauses* [See Figure 3; see **RPI** Form 552 §17]; and
- *nondisturbance clauses*.

The attornment clause allows an owner-by-foreclosure who acquires title at a foreclosure sale on a trust deed senior to the tenant's leasehold interest to unilaterally avoid the automatic elimination and unenforceability of a junior leasehold interest by the foreclosure sale.

The *lender subordination clause* gives a senior trust deed lender the right to unilaterally subordinate the lender's trust deed to a previously junior leasehold interest by written notice to the tenant prior to the foreclosure sale. Thus, the leasehold interest in title is not wiped out by a foreclosure of the lender's trust deed; the trust deed has been subordinated and the leasehold has priority.

Under a *future subordination clause*, the tenant agrees to subordinate their leasehold interest in the property to a trust deed to be recorded in the future. Here, the tenant remains involved since they need to sign a specific subordination agreement to give the later recorded trust deed priority to their leasehold interest in the property.

The *nondisturbance clause* when included in a lease agreement is coupled with a future subordination clause. These two clauses, paired together, allow the tenant's leasehold interest in the property to remain unaffected for its full term even though the tenant subordinates their leasehold to the lender's trust deed.

A knowledgeable lender will require the landlord's lease agreements to include both a lender subordination clause and an attornment clause as a condition for the lender's consent to the landlord's leasing of space or units in the mortgaged property. The future subordination clause is included in a lease agreement for the benefit of the landlord only.

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5 **Dover Mobile Estates** v. **Fiber Form Products, Inc.** (1990) 220 CA3d 1494

The attornment clause and foreclosure

To enforce a lease agreement which includes an **attornment clause** and reinstate the leasehold wiped-out by the foreclosure sale, the owner-by-foreclosure notifies the tenant they have elected to be the substitute landlord under the tenant's lease agreement. Thus, the tenant's leasehold interest is restored. However, the owner-by-foreclosure need not exercise their right to enforce the lease agreement, leaving the wiped-out tenant with no interest in the property.

attornment clause
A lease agreement provision which allows an owner-by-foreclosure to unilaterally avoid the automatic elimination of a junior leasehold interest by a foreclosure sale and become a substitute landlord under the tenant's lease agreement. [See **RPI** Form 552-8 §3]

A commercial landlord has financial justification to include an attornment clause in a lease agreement. When a senior trust deed lender forecloses, it is essential for the landlord losing ownership by foreclosure to maintain the property's value. In the event the lender judicially forecloses, the future rents collectible under an advantageous lease agreement reduces the potential of a deficiency judgment for lost property value. [See Figure 1; see **RPI** Form 552-8 §3]

A financially advantageous lease agreement, enforceable by new owners after a foreclosure, will help maintain the value of the property. On the other hand, when a financially advantageous lease agreement does not contain an attornment clause, the property's market value will be lower than had the owner-by-foreclosure been able to enforce the lease agreement and restore the tenant's leasehold interest.

When an owner-by-foreclosure elects to enforce a financially advantageous lease agreement under its attornment clause, the lease agreement remains effective to enforce collection of rent for the remainder of its term as scheduled in the lease agreement.

Thus, the owner-by-foreclosure who makes the attornment election becomes the substitute landlord. As the new landlord, they will perform the obligations of the landlord under the lease agreement.[6]

Before the foreclosing lender or other purchaser at a foreclosure sale chooses to become the successor landlord, they will consider whether the lease agreement provides for rents at or above market rates. To help make the attornment decision, the owner-by-foreclosure:

- obtains the equivalent of a *tenant estoppel certificate (TEC)* from each tenant to discover if the prior landlord has breached their lease agreement [See **RPI** Form 598]; and
- inspects the property to be assured its physical condition is acceptable to the owner-by-foreclosure.

Subleases and attornment

Lease agreements allowing a tenant to sublet the use and occupancy of all or portions of the property to others, known as *subtenants*, contain *restriction-on-transfer provisions*. These are also known as *restraint-on-alienation provisions*, *transfer restrictions* or *assignment and subletting provisions*. [See **RPI** Form 552-7]

6 Miscione, *supra*

Under a prohibition of subletting, the tenant is to first obtain the landlord's consent to sublet. When setting up the guidelines for consenting to a sublease agreement, the landlord requires an *attornment provision* to be included in the lease agreement with the subtenant.

If the landlord ever terminates the master tenant's right of possession under a three-day notice and forfeiture, the landlord may enforce the sublease agreement by exercising their right to be the substitute landlord provided by the attornment clause.

The landlord electing to enforce the sublease agreement under the attornment election is substituted as the landlord (sublessor) under the lease agreement. Due to the election, the subtenant will continue paying rent as agreed, but to the new landlord.

No assurance of continued occupancy

Conversely, an attornment clause does not give the tenant the reciprocal right to enforce the lease agreement against the buyer at the foreclosure sale. The attornment agreed to by the tenant to recognize the buyer as their landlord is not triggered until the owner-by-foreclosure elects to enforce the provision.

Thus, a tenant who enters into a lease agreement with an attornment clause, whose leasehold is junior to a lender's trust deed, has no assurance the leasehold will be restored on the lender's foreclosure.

Yet tenants, when agreeing to an attornment clause, believe the clause states the obvious — the tenant will perform on the lease agreement for anyone who becomes the new owner of the property. The tenant views it as a *nondisturbance agreement* with the lender, but it is not. The lender is not a party to a subordinate lease agreement and has agreed to nothing contained in it.

However, when a junior leasehold is eliminated at a foreclosure sale, the owner-by-foreclosure is unlikely to elect to enforce the lease agreement if:

- the owner-by-foreclosure acquired the property to occupy it as a user; or
- the rents due under the exhausted lease agreement are significantly less than the rents available in the market.

The tenant protects their interest

Further, a tenant will regret the inclusion of an attornment clause when:

- rents called for in the lease agreement exceed market rates at the time of foreclosure, as in a time of recession; or
- the location or premises are no longer desirable for the tenant when a foreclosure sale occurs, such as economic obsolescence.

All these foreclosure related events typically converge during economically depressed times for all involved, not when the lease agreement is entered into.

Avoidance of the adverse impact of an attornment

For a tenant to avoid the unilateral adverse economic impact of an attornment clause upon entering into a long-term lease, the tenant is best served by a leasing agent who:

- obtains an abstract of title or lessee's policy of title insurance to ascertain the trust deeds and other liens of record and the risk of loss they present to the tenant, after initially pulling a title profile from a title insurance company;
- obtain beneficiary statements or other assurance of mortgage balances and defaults on the mortgages/liens of record;
- records a request for notice of default (NOD) [See **RPI** Form 412 and 412-1]; and
- records a request for notice of delinquency (NODq) on the lender. [See **RPI** Form 412 and 412-2]

With the information from these documents, the tenant is positioned to take timely steps to protect their interest when the landlord defaults on senior liens or the underlying ground lease, long before any foreclosure sale occurs to terminate the tenant's lease.

Notifying the tenant

An owner-by-foreclosure elects to enforce the tenant's lease agreement under an attornment clause. The owner-by-foreclosure gives the tenant a written notice:

- stating the owner-by-foreclosure is exercising their right to enforce the lease agreement under the attornment clause; and
- instructing the tenant to make all future rent payments due under the lease agreement to the owner-by-foreclosure.[7]

The attornment clause indicates a specific time period within which the owner-by-foreclosure is to notify the tenant it they elect to enforce the lease. [See Figure 1]

The owner-by-foreclosure loses the right to enforce the attornment clause when:

- the attornment clause does not contain a specific time period for enforcing recognition of the owner-by-foreclosure as landlord; and
- the owner-by-foreclosure does not elect to enforce the lease agreement within a *reasonable period of time*.

No right to continued occupancy

Instead of exercising the right to retain a lease, the owner-by-foreclosure of a commercial property may choose to serve the tenant with a three-day notice to quit due to foreclosure. This notice gives the landlord the right to evict the tenant by unlawful detainer (UD) when the tenant remains in possession past the three-day notice period.[8] [See **RPI** Form 578]

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7 Miscione, *supra*

8 Calif. Code of Civil Procedure §1161a(b)

The three-day notice is served as soon as possible to avoid conduct by the landlord or property manager that could be construed as an enforcement of the lease.

For example, an owner-by-foreclosure under a senior trust deed who elects not to enforce the lease agreement may not accept rent from the tenant. Accepting rent in the amount called for in the lease agreement may indicate the owner-by-foreclosure intends to accept the lease under its attornment clause, regardless of the owner-by-foreclosure's actual intent.[9]

When the owner-by-foreclosure accepts rent payments from a tenant following the sale of the property under a senior trust deed and an attornment clause does not exist in the extinguished lease, a *periodic tenancy* is created. Here, neither the tenant nor the owner-by-foreclosure can enforce the lease agreement since the tenant's leasehold interest has been eliminated.[10]

Lender subordination clauses

A commercial lender requiring an attornment clause in a lease agreement will also require the landlord to include a **lender subordination clause** in the lease agreement. The lender subordination clause allows the lender to elect to subordinate its trust deed lien to leases the landlord enters into after the trust deed is recorded. [See Figure 2; see **RPI** Form 552-8 §2]

lender subordination clause
A lease agreement provision which gives a lender with a trust deed interest senior to the tenant's leasehold interest the right to unilaterally subordinate the lender's trust deed to the tenant's leasehold by written notice to the tenant.. [See **RPI** Form 552-8 §2]

A lease agreement containing both a lender subordination clause and an attornment clause gives the lender flexibility to:

- subordinate its trust deed to the leasehold before the foreclosure sale under the lender subordination clause and then enforce the lease agreement after foreclosure;
- complete a foreclosure sale and exercise the attornment clause to enforce the lease agreement by acting within the attornment election period; or
- do neither and treat the tenant as a holdover in unlawful possession.

Some attornment clauses are worded to state the lender acquires the premises "subject to" the leasehold at the time of the foreclosure sale.

No automatic subordination

Occasionally, an attornment clause in a lease agreement literally states the lender is to acquire the property "subject to" the lease. However, the attornment clause does not automatically subordinate the trust deed to the leasehold when a foreclosure sale occurs since the lender is not a party to the lease agreement. The lender did not agree to the terms of the lease agreement, even when the lender previously reviewed it and waived due-on clause enforcement by consenting to the lease.

When the lender notifies the tenant prior to the foreclosure sale of its election to subordinate its trust deed lien to the tenant's lease, the election need not be recorded to give public notice. The change in priority only

9 **Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292
10 **Colyear** v. **Tobriner** (1936) 7 C2d 735

Figure 2

Excerpt from Form 552-8

Lender Subordination and Attornment Provisions

2. **Lender subordination clause:** Any master lessor or holder of a lien on the leased premises may elect to subordinate its interest in the premises to this lease by service of written notice on Tenant of the election, and thereafter Lease will have priority regardless of the priorities set by law.

affects the parties to the agreements, namely the lender, the tenant and their successors who are charged with knowledge of the provision's existence in the lease agreement.[11]

A trust deed that becomes junior to a tenant's leasehold interest in the property by the lender's election to subordinate prior to foreclosure gives the leasehold priority over the trust deed. Thus, the tenant's leasehold interest is not eliminated from title by the foreclosure sale under the now-junior trust deed.

When the leasehold is not wiped out at the foreclosure sale because of the lender's prior election to subordinate, a later election under the attornment clause after foreclosure becomes unnecessary.

When a lender elects to subordinate its trust deed to the lease, the high bidder at the foreclosure sale acquires the property *"subject to"* the tenant's leasehold interest since the leasehold has priority over the trust deed.

After the foreclosure sale, by either a prior election by the lender to subordinate or a later election to have the tenant attorn to the owner-by-foreclosure, the lease agreement becomes enforceable by both the tenant and the new landlord.[12]

Electing to subordinate

Now consider a lender holding a first trust deed on commercial real estate. After the trust deed is recorded, the landlord enters into a lease agreement granting a tenant a leasehold interest in the property.

The lease agreement contains a lender subordination clause, included to satisfy the lender's conditions for waiver of the due-on clause in their trust deed as consent to the landlord entering into a lease agreement with a term greater than three years.

During the term of the lease, the landlord defaults on the lender's trust deed. The lender records an NOD, initiating a trustee's foreclosure. The lender has the property appraised and discovers the rent due over the remaining term of the tenant's lease exceeds current prevailing rental rates.

For the same economic reasons that cause the lender to decide to preserve the lease agreement, the tenant wants out of the lease agreement.

11 CC §1217

12 Miscione, *supra*

Before holding the trustee's sale, the lender becomes aware of negotiations between the landlord and the tenant to modify the lease agreement. The lender does not want the landlord to alter the agreement prior to foreclosure and an attornment. The lender serves written notice on the tenant of its exercise of the election to subordinate the trust deed to the tenant's lease. This notice alters priorities, subordinating the lender's trust deed to a position junior to the tenant's leasehold interest and the terms of the lease agreement.

After receipt of the notice of subordination, the tenant and the landlord modify the lease agreement, granting the tenant the right to terminate the leasehold and cancel the lease agreement at any time on 30 days' written notice, in exchange for the tenant paying the landlord a modification fee.

The trustee's sale is held and the lender acquires the property. The lender notifies the tenant that the lender is the owner-by-foreclosure of the property and all rent payments under the lease agreement are to be made to the lender. The tenant serves the lender with a written 30 days' notice exercising the tenant's election to terminate the leasehold and cancel the lease agreement under the lease modification agreement.

The lender claims the tenant cannot terminate the leasehold or cancel the lease agreement since the modification agreement, but not the original lease agreement, was rendered ineffective as against the lender by the foreclosure sale.

Lender subordination prior to modification

Can the tenant in the previous example terminate the leasehold by canceling the lease agreement under the conditions stated in the lease modification entered into prior to the landlord's loss of the property to foreclosure?

No! The original terms of the lease agreement and the right of occupancy held by the tenant remain unaffected by the foreclosure sale. The lender had elected to subordinate their trust deed to the leasehold and lease agreement prior to the tenant entering into the modification of the lease agreement. Thus, the agreement modifying the lease agreement for termination of the leasehold is unenforceable against the subordinate lender.

The modification agreement was junior in time to the subordination of the trust deed. On subordination, the leasehold became a senior (unrecorded) encumbrance on title to the property with priority to the lender's trust deed, a condition unalterable without the lender's consent.[13]

By the lender subordinating its trust deed to the tenant's leasehold, the lender acted to maintain the property's value based on future rents scheduled in the lease agreement at the time of the subordination. Subordination allows the lender to avoid the effect of any later modification of the lease agreement prior to foreclosing and acquiring ownership at the trustee's sale.

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13 **In re 240 North Brand Partners, Ltd.** (9th Cir. BAP 1996) 200 BR 653

Figure 3

Excerpt from Form 552

Gross — Single Tenant

17. SUBORDINATION:

17.1 Tenant agrees to subordinate the leasehold estate to any new financing secured by the Premises which does not exceed 80% loan-to-value ratio, and interest of 2% over market, and not less than a 15-year monthly amortization and 5-year due date.

In the event the lender proceeds with a judicial foreclosure, the landlord would normally prefer for the property to remain encumbered by a financially advantageous lease agreement to avoid a deficiency in the property's value as insufficient to satisfy the mortgage at the time of a judicial foreclosure sale.

Thus, the risk of loss due to a deficiency in the value of the property at the time of the remaining judicial foreclosure sale is reduced for both the lender and the landlord. The tenant, however, is required to pay future rent as scheduled in the leasing agreement.

Future subordination clauses

A landlord's ability to further encumber or refinance their property during the term of a lease is greatly diminished unless the lease agreement contains a **future subordination clause**. [See Figure 3]

future subordination clause
A lease agreement provision in which the tenant agrees to subordinate their leasehold interest in property to a trust deed to be recorded in the future. [See **RPI** Form 552 §17]

Like the attornment clause and lender subordination clause, a future subordination clause is an agreement to alter priorities on title. Under a future subordination clause, the tenant agrees to subordinate their leasehold (right of possession) to a trust deed to be recorded by the landlord sometime in the future.

Thus, the tenant agrees to place their leasehold in a financially junior position on title, whether or not the lease agreement is recorded, than they enjoyed at the time they entered into the lease agreement and took possession. The tenant's leasehold will be subordinated to a new trust deed based on the terms agreed to in the future subordination clause.

For a future subordination clause to be enforceable at the time the landlord arranges a new trust deed lien, the clause needs to specify:

- the use of the mortgage proceeds, such as refinancing existing encumbrances or improving the property;
- the dollar amount of the mortgage or the loan-to-value ratio of the financing;
- the payment schedule;
- the interest rate; and
- the due date.[14]

14 **Handy** v. **Gordon** (1967) 65 C2d 578

The clause also contains any other terms that might be unique to the future financing that would, if agreed to by the tenant, further impair the tenant's lease.

When the landlord later arranges financing for the property on terms within the parameters agreed to in the subordination clause, the tenant is obligated to sign a specific subordination agreement. The agreement to subordinate needs to set out the specifics of the mortgage to which the tenant's leasehold will be subordinate. A title company will not insure the priority of the new trust deed over the tenant's recorded or unrecorded leasehold interest without a tenant-executed *subordination agreement*. Automatic subordination agreements are not enforceable.

Tenant refusal to sign

However, the tenant may properly refuse to sign a subordination agreement when the financing terms are not substantially similar or within the parameters of the subordination clause in the lease agreement. The tenant has not agreed to subject their lease to the uncertainties of a greater risk of loss than the risks established by the terms of the lease agreement's future subordination clause.

Editor's note — When the landlord wants to record a new trust deed to secure a mortgage and the tenant refuses to sign a specific subordination agreement, the landlord's primary recourse is to serve a three-day notice to perform or quit. When performance is not forthcoming, the landlord may file a UD action to evict the tenant or file an action against the tenant for declaratory relief and specific performance of the future subordination clause in the tenant's lease agreement.

Nondisturbance and subordination clauses

A **nondisturbance clause** gives the tenant the right to require a new trust deed lender to enter into a written agreement with the tenant, called a **nondisturbance agreement**. The *nondisturbance agreement* states the tenant's leasehold interest will remain in effect for its full term under the lease agreement after the leasehold is subordinated to a new mortgage.

A nondisturbance clause is included in a lease agreement only when the lease agreement also contains a *future subordination clause*. The tenant is the primary beneficiary of the *nondisturbance clause*.

> **nondisturbance clause**
> A lease agreement provision which is coupled with the future subordination clause to allow a tenant's junior leasehold interest to remain unaffected by a lender's foreclosure under a senior trust deed. [See **RPI** Form 552-8]

A nondisturbance clause is typically used by the landlord and leasing agents to avoid negotiating the terms of a subordination clause with the tenant when initially hammering out the terms of the lease agreement.

When the nondisturbance clause and an enforceable future subordination clause are included in a lease agreement, the tenant may refuse to sign a subordination agreement unless the lender provides the tenant with a nondisturbance agreement. Any standoff between the tenant and the lender poses a serious problem to a landlord attempting to record financing.

Informed lenders on originating a mortgage secured by a first trust deed are not likely to provide a tenant with a nondisturbance agreement when a tenant has agreed to subordinate their leasehold to the lender's trust deed lien. Without the subordination of the leasehold to the new trust deed, no reason exists for the tenant to have a nondisturbance agreement.

nondisturbance agreement
An agreement with mortgage lender providing for the tenant's lease agreement to remain in effect for its full term after the leasehold is subordinated to a new mortgage.

A nondisturbance agreement negates the effect of the subordination agreement by reversing the very priorities agreed to by subordinating the leasehold to the trust deed, a sort of *self-destruct provision*. The lease, in effect, will not be subordinate to the lender's trust deed if the lender agrees to recognize the continued existence of the leasehold after a foreclosure of the trust deed.

Future subordination clause benefits the landlord

A knowledgeable landlord, contrary to the needs of a tenant, does not want a nondisturbance clause in the lease agreement. Landlords are better served by an enforceable *future subordination clause*.

Unlike the purpose of an attornment clause, a leasehold that is subject to a nondisturbance agreement will not be eliminated by foreclosure nor need to be later restored by election of the owner-by-foreclosure. The nondisturbance agreement states the leasehold will remain in effect for its full term without regard to foreclosure.

Since the leasehold subject to a nondisturbance agreement with the lender is not extinguished by foreclosure, it cannot also be junior to the trust deed.

Thus, a subordination of the leasehold to the trust deed does not occur when the lender concurrently enters into a nondisturbance agreement.

Also, when a new lender executes a nondisturbance agreement, an attornment clause serves no purpose for the lender's trust deed rights. Like many clauses in some lease agreements, it makes other provisions superfluous.

The tenant's possession and lease agreement when subject to a nondisturbance agreement remains undisturbed and continuously enforceable by both the tenant and the owner-by-foreclosure after the foreclosure sale.

By entering into a nondisturbance agreement, the lender (or other high-bidder at the foreclosure sale) is forced to become the landlord under the lease agreement if the lender forecloses.

A landlord eliminates the issue of a nondisturbance clause in a lease agreement by their leasing agent negotiating an enforceable future subordination clause outlining the mortgage parameters acceptable to both the landlord and the tenant when entering into the lease. By doing so, the landlord placates both the tenant and any future lenders that might otherwise balk at a lease agreement requiring the landlord to deliver a nondisturbance agreement from a new lender.

Chapter 31 Summary

Commercial lease agreements often contain boilerplate provisions relating to the priority of the leasehold against trust deeds, present and future. These provisions include:

- attornment clauses;
- lender subordination clauses;
- future subordination clauses; and
- nondisturbance clauses.

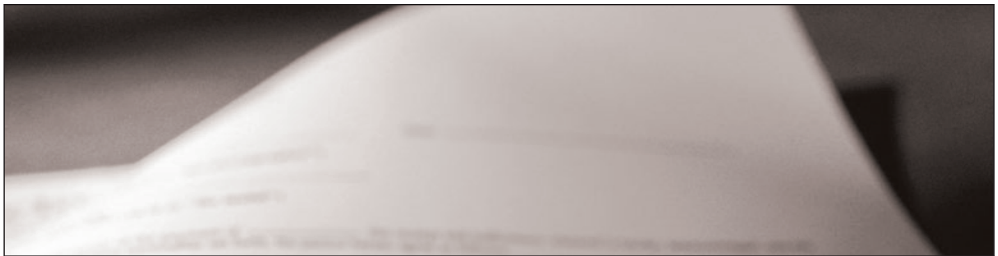
An attornment clause allows an owner-by-foreclosure who acquires title at a foreclosure sale on a senior trust deed to unilaterally avoid the automatic elimination and unenforceability of a junior leasehold by the foreclosure sale.

A lender subordination clause gives a senior trust deed lender the right to unilaterally subordinate the lender's trust deed to a previously junior leasehold interest by written notice to the tenant.

Under a future subordination clause, the tenant agrees to subordinate their leasehold interest in the property to a trust deed to be recorded in the future.

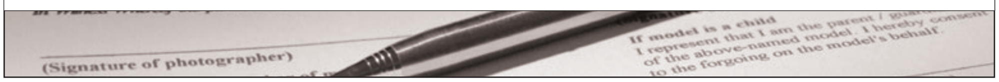
A nondisturbance clause, when coupled with a detail-deficient future subordination provision, allows a tenant's junior leasehold interest to remain unaffected by a foreclosure under a new trust deed which is given priority to the lease.

Chapter 31 Key Terms



Chapter 32

Tenant estoppel certificate



Learning Objectives

After reading this chapter, you will be able to:

- understand the obligations imposed by a Tenant Estoppel Certificate (TEC); and
- use a TEC on the sale or financing of tenant-occupied property.

Key Terms

annual property operating data sheet (APOD)

Tenant Estoppel Certificate (TEC)

Protection for buyers and lenders

A real estate broker representing an owner who wants to sell or refinance their tenant-occupied property customarily prepares an **annual property operating data sheet (APOD)** form to be included in the marketing package. The completed *APOD* is handed to prospective buyers and lenders to induce them to enter into a transaction with the owner. [See **RPI** Form 352]

annual property operating data sheet (APOD)
A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

An APOD prepared on a due diligence review of the property provides buyers and lenders with an accurate summary of financial information on the operating income and expenses generated by the property.

Buyers and lenders who rely on APOD figures need to corroborate the income and expense numbers and other leasing arrangements prior to closing. A strategic method is to condition the closing on their receipt and further approval of **Tenant Estoppel Certificates (TEC)**, one signed and returned by each tenant occupying the property. [See Form 598 accompanying this chapter]

The *TEC* summarizes the financial and possessory terms of the tenant's lease agreement, and whether the landlord and tenant have fully performed their obligations.

Tenant Estoppel Certificate (TEC)
A statement which summarizes the monetary and possessory terms of a lease agreement, and whether the landlord and tenant have fully performed their obligations. [See **RPI** Form 598]

The objective of the TEC is to confirm the current status of:

- rent schedules;
- security deposits;
- possessory and acquisition rights; and
- the responsibility for maintenance and other operating or carrying costs.

Thus, the TEC will reveal any option or first refusal rights held by the tenant to:

- extend or renew the lease;
- buy the property;
- lease other or additional space; or
- cancel the lease on payment of a fee.

However, the lease agreement needs to contain a TEC provision before the owner may require a tenant to sign and return a TEC to confirm the leasing arrangements. [See Figure 1; see **RPI** Form 552 §18]

The TEC provision calls for the tenant to:

- sign and return a TEC, which has been filled out and sent to them, within a specific period of time after its receipt; or
- waive their right to contest its contents if the tenant fails to sign and return the TEC submitted for their signature.

Tenant response on receipt of a TEC

In addition, a TEC includes a statement indicating a buyer or lender will rely on the information provided by the TEC when making a decision to lend or purchase. [See **RPI** Form 598 §10]

In the TEC, the tenant acknowledges the accuracy of its contents by either:

- signing and returning it; or
- failing to respond, which waives the right to contest the accuracy of its contents.

Either way, a buyer or lender may rely on the TEC's content as complete and correct statements on the terms and condition of the lease.[1]

The properly submitted TEC prevents any later claims made by the tenant in a dispute with the buyer or lender that its terms are in conflict with the contents of the lease agreement.

A buyer or lender asserts their right to rely on and enforce the terms stated in the TEC by presenting the tenant's TEC as a defense to bar contrary claims made by the tenant, called **estoppel**. Thus, the tenant is *estopped* from denying the truth of the information in the TEC or later claiming conflicting rights.

1 Calif. Evidence Code §623

18. TENANT ESTOPPEL CERTIFICATES:

18.1 Within 10 days after notice, Tenant will execute a Tenant Estoppel Certificate verifying the existing terms of the lease agreement to be provided to prospective buyers or lenders. [See **RPI** Form 598]

18.2 Failure by Tenant to deliver the Certificate to Landlord will be conclusive evidence the information contained in the Certificate is correct.

Figure 1

Excerpt from Form 552

Gross — Single Tenant

Security deposits confirmed

Lease agreements entered into by tenants and the seller of income property are assigned to a buyer by the seller on the close of a sale. As part of the adjustments and prorates at closing, the buyer requires the seller, through escrow, to account for any security deposits collected from the tenants. The amount of the remaining security deposits goes to the buyer as part of the escrow process, called **adjustments**.

With a TEC, the tenant confirms the accounting and dollar amount of security remaining on deposit with the seller. Thus, the TEC avoids the transfer of insufficient amounts of security deposits on closing and establishes the extent of the buyer's liability for refunds due the tenant.

The buyer needs to condition their purchase on receipt of TECs to confirm the current accounting of the security deposits. Otherwise, the buyer may be required to pay tenants more than the security deposit amounts they received from the seller on closing.[2]

Any deficiency in the amount of credit the buyer receives on closing for security deposits the buyer is later required to pay to the tenants is recovered by pursuing the seller.

TEC substantiates prior representations

A completed APOD form received by a buyer presents an accounting summary of a property's income and expenses. It represents the present income flow and operating expenses a prospective buyer can expect the property to generate in the immediate future.

Prior to closing, the buyer needs to:

- review and analyze all the lease agreements the owner has entered into with the tenants;
- compare the results of an analysis of rent and maintenance provisions in the lease agreements to the figures in the APOD received before the offer was submitted; and
- confirm the rent schedules, possessory rights, maintenance obligations and expiration of the leases by serving conforming TECs on the tenants and reviewing their responses before closing.

2 Calif. Civil Code §1950.5(i)

Form 598

Tenant Estoppel Certificate

TENANT ESTOPPEL CERTIFICATE

NOTE: This form is used by an escrow officer or owner's broker when handling the sale or refinance of a tenant-occupied property which is contingent on confirmation of rents, deposits and other leasing arrangements between the tenant and owner, to provide the buyer or lender a summary of the financial and possessory terms of the tenant's lease agreement and whether the owner and tenant have fully performed their obligations.

DATE: _______________, 20 _____, at ______________________________, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This certificate pertains to terms and conditions under the following agreement:

Lease agreement Month-to-month rental agreement ______________________

1.1 dated _____________, 20_____, at ______________________________, California.

1.2 entered into by ______________________________, as the Landlord,

1.3 and ______________________________, as the Tenant,

1.4 regarding real estate referred to as ______________________________
______________________________.

STATEMENT:

Tenant certifies as follows:

2. The rental or lease agreement is:

Unmodified and in effect.

Modified and in effect under a modification agreement dated ___________, 20 _____.

3. Tenant is in possession of the premises, and has not assigned or sublet any portion of the premises, except ______________________________.

4. If the agreement is a lease, the current term is for ______ years, ending ____________, 20______.

4.1 Lease term under all renewal/extension options will run until ______________, 20 ______.

4.2 Tenant holds no privilege to terminate the lease prior to its expiration.

5. The amount of monthly rent is $_____________.

5.1 No incentives, bonuses, free rent, discounts or refunds on the rental amount were given Tenant, except ______________________________.

5.2 Rent is paid through the period ending ______________, 20 ______.

5.3 Tenant has not prepaid future rent, except the amount of $______________ for the rental period of ______________________________.

5.4 No Tenant liens, claims, offsets or charges exist against Landlord, except ______________________________
______________________________.

6. A security deposit of $________________ is held by Landlord to cover any expenses or losses caused by Tenant's breach of the agreement.

7. Personal property in Tenant's possession and owned by Landlord includes ______________________________
______________________________.

8. Any improvements required to have been made by Landlord or Tenant have been satisfactorily completed.

9. No breach of the agreement by Landlord or Tenant presently exists, except ______________________________
______________________________.

10. Tenant holds no contract, option or right of first refusal or other right to buy any interest in the real estate.

10.1 Tenant holds no right to lease additional or substitute space in the real estate.

11. Tenant has caused no lien or encumbrance to attach to the leasehold interest in the property.

12. Tenant understands this certificate will be relied on by a buyer of the property or a lender secured by the real estate.

13. ______________________________
______________________________.

I certify the above is true and correct.

Date: ____________, 20____

Tenant's Name: ______________________________

Signature: ______________________________

Phone: ____________________ Fax: ____________________

FORM 598 03-11

Close on receipt of TECs

When signed and delivered to the buyer, the TEC statement reflects the financial and possessory arrangements existing at the time the tenant signs and returns the TEC.

Consider a tenant who signs and returns a TEC that is reviewed and approved by the buyer. However, before escrow closes, the seller breaches, modifies or enters into other leasing arrangements with the tenant.

The seller's post-TEC activities are not noted on the TEC, and will be unknown to the buyer when escrow closes unless brought to the buyer's attention. Thus, on receiving the TECs, a buyer or lender needs to review them and close the transaction as soon as possible to avoid a change in conditions in the interim.

The Tenant Estoppel Certificate (TEC) verifies the following:

- *whether possession is held under a lease or rental agreement;*
- *the current monthly amount of rent and the basis for rent increases;*
- *the date rent is paid each month;*
- *the date to which rent has been paid;*
- *any incentives given to obtain the tenant;*
- *whether the tenant has prepaid any rents;*
- *the term of the lease and whether an early cancellation privilege exists;*
- *whether and in what manner the lease/rental agreement has been modified;*
- *whether the tenant holds any options to renew or extend, acquire additional or substitute space, or a right of first refusal to rent vacated space;*
- *whether the tenant holds any options to buy the real estate;*
- *the amount and status of any security deposit;*
- *any improvements the tenant needs to or can remove on vacating the premises;*
- *any landlord commitments to further improve the premises;*
- *whether the landlord or tenant is in breach of the lease or the rental agreement; and*
- *whether the tenant has assigned or sublet the premises, or liened their leasehold interest.*

Figure 2

Status of the lease

Consequence of no TEC

A buyer or lender may be confronted at the time of closing with a tenant who has not signed and returned a TEC. Before closing, it is good practice for the buyer and their agent to investigate whether differences actually exist between the owner's representations on the TEC and the tenant's expectations under the lease agreement.

The buyer or lender may legally rely on the contents of an unreturned TEC when the tenant's lease agreement contains a TEC clause. However, an inquiry by the buyer or their agent into the tenant's failure to return the TEC is a prudent measure to prevent future surprises.

Consider an owner of income-producing real estate who needs to generate cash. They will do so by borrowing money using the equity in their property as security for repayment of the mortgage.

Tenants occupy the property under lease agreements that include options to renew at fixed rental rates. The lender does not condition the origination of the mortgage on the lender's receipt and approval of TECs from each tenant. The lender, unfamiliar with real estate ownership interests, makes the mortgage based on the value of comparable properties without regard for a schedule of the tenants' rent. [See **RPI** Form 380]

The owner defaults. The lender forecloses and acquires the property at the trustee's sale. As the new owner, the lender reviews the rent being paid by the tenants.

Case in point

Signing an erroneous TEC

Consider a tenant who signs and returns unaltered a Tenant Estoppel Certificate (TEC) on the landlord's sale of commercial property. The TEC is erroneously prepared, stating an expiration date earlier than the date for termination provided in the lease agreement.

The buyer relies on the TEC and purchases the property. The tenant remains in possession of the premises after the expiration date stated in the TEC. The buyer seeks to enforce the expiration date in the TEC by filing an unlawful detainer (UD) action to evict the tenant.

The tenant claims the buyer cannot enforce the expiration date in the TEC by a UD action since the TEC was not a written agreement modifying the lease, binding them to a different expiration date than actually stated in the lease agreement. The buyer claims the tenant is barred from contradicting the expiration date stated in the TEC.

*Here, the new landlord may enforce the expiration date in the TEC and evict the tenant by a UD action. The TEC is a statement signed by the tenant certifying facts with respect to the lease which were relied on by the buyer. Thus, the tenant is barred from later using the contrary provision in the lease agreement to contradict the TEC. [**Plaza Freeway Limited Partnership** v. **First Mountain Bank** (2000) 81 CA4th 616]*

Consequence of no TEC, cont'd

The new owner decides to increase the rents to current market rates in order to bring the property's market value up to prices recently received on the sale of comparable properties. However, the tenants who occupied the premises before the lender's trust deed was recorded claim their lease agreements, which provide options to extend at old rental rates, are enforceable against the lender as the new owner.

The lender claims their foreclosure sale wiped out all the owner's rights in the property and established the lender as the new title holder with priority over the leases. Further, the lease agreements were not recorded.

May the tenants who occupied the property prior to the recording of the lender's trust deed enforce their renewal options even though their pre-existing lease agreements were not recorded?

Yes! The lender originating a trust deed mortgage on income-producing property they now own by foreclosure recorded the trust deed after the tenants were in possession of the property. Thus:

- the tenants' rights and obligations under lease agreements, recorded or not, retain priority over the lender's trust deed lien recorded after the tenants were in possession; and
- the lender is bound by the rent schedules in the pre-existing lease agreements and renewal/extension options because of the seniority of the leases.[3]

The tenants' occupancy of the premises prior to originating the mortgage puts the lender on constructive notice, or knowledge, of the lease agreements, renewal options and rent schedules.[4]

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3 CC §1214

4 **Evans** v. **Faught** (1965) 231 CA2d 698

The condition for funding a mortgage requiring lender approval of a TEC from each tenant informs the lender of the tenants' rights and obligations to occupy and pay rent and other amounts under their lease agreements.

The owner's scheduled future income needs to represent amounts the tenants expect to pay. Every buyer or lender acquiring an interest in income-producing real estate needs to require tenant approval of TECs based on lease arrangements the owner/seller purports to hold with each tenant.

The erroneous, unsigned TEC

Now consider a purchase agreement for commercial rental property that requires the seller to provide the buyer with TECs for the buyer's further approval or cancellation of the purchase agreement.

One tenant's lease agreement does not state the rent amounts but contains a formula for calculating rent. The seller instructs the buyer on how to calculate the rent due from the tenant based on the provisions in the tenant's lease agreement.

The seller enters the rent amounts on the TEC based on the same calculations given the buyer and sends it to the tenant to be signed and returned to the buyer.

The tenant refuses to sign the TEC since the tenant is not obligated under their lease agreement to provide a TEC. The seller hands the buyer a copy of the tenant's unsigned TEC to satisfy the purchase agreement condition. The buyer accepts it without further investigation and confirmation.

After escrow closes, the buyer discovers the tenant's actual rent is significantly lower than the seller's estimate. The buyer makes a demand on the seller for the difference between the actual rent paid by the tenant under the lease and the rent amounts calculated by the seller to be paid by the tenant.

Is the seller liable for the difference in the rent?

Yes! The buyer recovers lost rent from the seller in the amount of the difference between the seller's calculated estimate of rent and the actual amount owed by the tenant. The seller is obligated under the purchase agreement to provide the buyer with an accurate TEC. The buyer based their decision to purchase the property on representations made by the seller, not on the rent provisions in the lease agreement.[5]

Sellers avoid liability

A seller avoids liability for errors in the TEC prepared and sent to tenants by including a TEC clause in the tenant's lease agreement, calling for the tenant to sign and return a TEC on request. The failure of the tenant to provide the TEC as called for in the lease agreement is conclusive evidence any contrary information contained in the TEC is correct. [See Figure 1]

Thus, a tenant's refusal to sign a TEC when a TEC clause exists in the lease agreement results in the tenant, not the seller, being liable for the erroneous rent amount stated in the TEC prepared by the seller.

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5 **Linden Partners** v. **Wilshire Linden Associates** (1998) 62 CA4th 508

Chapter 32 Summary

The Tenant Estoppel Certificate (TEC) summarizes the monetary and possessory terms of the lease agreement, and whether the landlord and tenant have fully performed their obligations.

The objective of the TEC is to confirm the current status of:

- rent schedules;
- security deposits;
- possessory and acquisition rights; and
- the responsibility for maintenance and other operating or carrying costs.

Thus, the TEC will reveal any option or first refusal rights held by the tenant to:

- extend or renew the lease;
- buy the property;
- lease other or additional space; or
- cancel the lease on payment of a fee.

Chapter 32 Key Terms

Chapter 33

Residential rental and lease agreements

Learning Objectives

After reading this chapter, you will be able to:

- distinguish the different terms for occupancy under residential rental and lease agreements;
- understand the operation of provisions of residential rental agreements and lease agreements;
- use addenda to incorporate additional terms into residential rental and lease agreements; and
- identify the statutory rights and duties of landlords and tenants as restatements in residential rental or lease agreements.

Key Terms

addendum	**rental market**
credit application	**waterbed addendum**

A review of periodic vs. fixed-term tenancies

Typically, residential landlords and tenants enter into either a *periodic rental agreement* or a *fixed-term lease agreement*. Residential periodic tenancies typically take the form of month-to-month rental agreements. [See **RPI** Form 551]

Residential rental and lease agreements each grant and impose on the landlords and tenants the same rights and obligations. Their differences lie in the expectation of continued occupancy and the obligation to pay future rent.

Recall that a *month-to-month rental agreement* runs for an indefinite period of time. It automatically renews monthly, and on the same terms, until modified or terminated by notice. [See **RPI** Form 551 §3]

Periodic tenancies may be terminated by either the landlord or tenant on 30 days' written notice. However, a residential landlord is to give the tenant at least 60 days' written notice if the tenant's occupancy has exceeded one year.[1]

On the other hand, a *lease agreement* creates a tenancy that continues for a fixed period. At the end of the fixed-period, the tenant's right of possession expires. The terms in the lease agreement set the expiration date, and no further notice is required by either the landlord or tenant to terminate the tenancy. [See Figure 1, Form 550 §3]

Unlike a periodic tenancy, the lease agreement does not automatically renew, unless an option to renew or extend has been written into the lease agreement and exercised.

Rental market influences

The **rental market** is the market environment in which landlords seek tenants (and vice versa). The condition of the *rental market* is determined by:

- the population of tenants;
- the number of properties competing for these tenants; and
- the comparative position of the property and its amenities in relation to competing properties.

rental market
The market environment in which landlords seek tenants and tenants seek landlords for the occupancy of property. The rental market sets the amount of rent a property will command on any given day.

The *rental market* sets the amount of rent a landlord is able to charge on any given day to solicit and induce prospective tenants to enter into rental or lease agreements.

Generally, tenants on month-to-month rental agreements pay higher amounts of monthly rent for a unit than do tenants with lease agreements. Month-to-month tenants pay a premium for the privilege of being able to vacate the premises on 30 days' notice, without liability exposure for future rents. This privilege held by the tenant contributes to the landlord's uncertainty about their income and costs of tenant turnover, hence the rent premium to cover the risks.

Tenants typically pay lower rents when they enter into a lease agreement. In stable rental markets, the longer the lease period the lower the rent.

Rent may, however, be subject to adjustments for future price inflation, local appreciation and management decisions. During weak market periods of generally high vacancy rates, price-competitive landlords may favor using month-to-month rental agreements rather than lease agreements. When rents begin to rise, landlords adjust rents to market by serving notice of a change in rent rates.

Lease negotiations on expiration

Conversely, a landlord may not alter the terms of a lease agreement during the life of the lease without consideration and the tenant's consent.

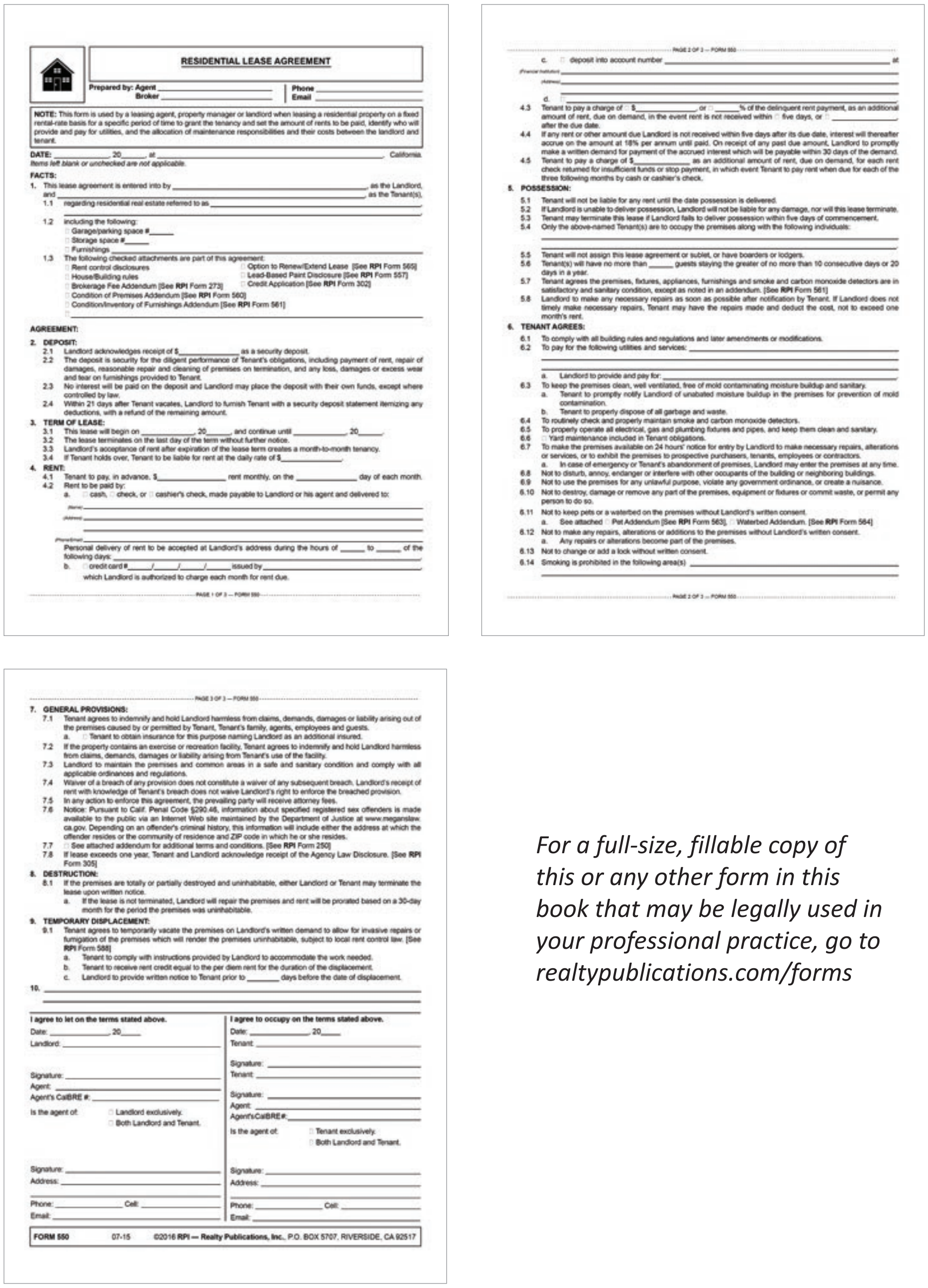
To extend a soon-to-expire lease agreement, the landlord may contact the tenant and offer to:

1 Calif. Civil Code §1946

Figure 1

Form 550

Residential Lease Agreement



RESIDENTIAL LEASE AGREEMENT

For a full-size, fillable copy of this or any other form in this book that may be legally used in your professional practice, go to realtypublications.com/forms

- enter into another lease agreement; or
- a month-to-month rental agreement.

If the tenant desires to remain in possession when their lease expires, the amount of rent a landlord may demand is limited only by negotiations and economic forces in the rental market, with the exception of rent control vicinities.

As an alternative, a landlord proactively negotiates and grants options to renew or extend when initially entering into lease agreements. The right to extend the occupancy may be all that is needed to induce the tenant to remain a tenant on expiration of the lease. [See **RPI** Form 565]

Requisites to accepting tenants

credit application
A document prepared by a prospective tenant which includes a provision authorizing the landlord to investigate and receive information on the tenant's creditworthiness. [See **RPI** Form 302]

On locating a prospective tenant for a residential unit, the landlord establishes the prospect's creditworthiness before entering into either a rental or lease agreement. This is accomplished by requiring the tenant to fill out a **credit application**. [See **RPI** Form 302]

The *credit application* is referenced and attached as an addendum to any rental or lease agreement entered into by the landlord and tenant. The application is part of the leasing process which persuades the landlord to accept the applicant as a tenant.

Initially, the landlord uses the authorization provided by the tenant on the application to verify the tenant's rental history, employment, credit standing and check-writing history.

If a prospective tenant has a poor credit rating or no credit rating at all, yet meets the landlord's income requirements, the landlord may seek assurances in addition to the maximum security deposit allowed. These assurances include:

- a co-signer on the lease; or
- a guarantee agreement signed by a creditworthy person. [See **RPI** Form 553-1]

With third-party assurances, the landlord will receive full performance on the lease agreement from others if the tenant defaults on their rent or otherwise causes the landlord to incur a loss exceeding the security deposit. On a default by the tenant, the landlord may hold the co-signer liable, or collect their losses from the guarantor. [See Sidebar, "Disclosing a notice of default"]

Landlord's right to avoid lawsuits

Every landlord has a duty to ensure the residential housing they rent is **safe and sanitary** throughout the tenant's occupancy. Additionally, a landlord has a duty to protect their tenants from *foreseeable* dangers.

Since environmental tobacco smoke (ETS) poses a legislatively recognized danger to tenants, a wise landlord takes steps to avoid claims.[2]

A landlord may do any of the following risk avoidance activities to alleviate the burden of future ETS disputes:

- relocate smokers so they will not affect non-smokers;
- relocate non-smokers so they are not affected by the ETS of smoking tenants; or

2 **Stoiber** v. **Honeychuck** (1980) 101 CA3d 903; Calif. Code of Civil Procedure §1174.2

Sidebar

Disclosing a notice of default to tenants

Owners of one-to-four unit residential rental property subject to a recorded notice of default (NOD) are required to disclose the NOD in writing to any prospective tenants before entering into a lease agreement.

If a landlord does not disclose the existence of a recorded NOD, the tenant may:

- *terminate the lease after a trustee's sale and recover all prepaid rent, plus the greater of one month's rent or twice the amount of money lost from the landlord; or*
- *if the foreclosure sale has not occurred, remain bound by the lease and deduct the amount of one month's future rent.*

The disclosure notice is required to be provided in English, and include Spanish, Chinese, Tagalog, Vietnamese and Korean translations.

It is the landlord's responsibility to ensure this notice is provided in the event an NOD has been recorded against the property. A property manager is not liable for failure to provide this notice, unless they neglect to provide the notice after being instructed by the landlord to do so. [Calif. Civil Code §2924.85]

- refuse to rent to persons who will not agree to the non-smoking provisions made a part of the rental or lease agreement.

Alternatively, the landlord may:

- designate all of the property as **smoke-free**, with the exception of any clearly defined areas where smoking will not affect others, by amending existing rental agreements or expired lease agreements; [See **RPI** Form 563-1] and
- enforce no smoking as part of the rules and policies of occupancy of the property through a "*property policies*" provision in the rental or lease agreement, then serve tenants who breach the no-smoking rule with a three-day notice perform (do not smoke) or quit (vacate). [See Figure 1, Form 550 §6.12; see **RPI** Form 576]

Nonsmoking addendum

The above policies may be **agreed upon** by the landlord and tenant by the use of a **Non-Smoking Addendum** when entering into a rental or lease agreement. The *Non-Smoking Addendum* either prohibits smoking on the entire premises, or notes the specific location on the property where smoking is permitted. [See **RPI** Form 563-1 §3]

A non-smoking policy may not be imposed on tenants under an existing fixed-term lease until renewal of the lease is negotiated, at which point the addendum may be attached. However, the use of a **property policies** provision in a lease agreement is a method for changing the rules on tenants during the term of a fixed-term lease.

However, tenants occupying under a month-to-month (periodic) rental agreement or an expired lease agreement may be given a 30-day Notice of Change in Rental Terms containing the non-smoking provision as the change. [See **RPI** Form 570 §7]

The tenant receiving a 30-day Notice of Change in Rental Terms does not need to sign a non-smoking addendum. The tenant, by remaining in possession and not giving notice to vacate, has by remaining silent agreed to the non-smoking provision. The non-smoking condition is enforceable on the running of 30 days from delivery of the notice.

Condition of premises addendum

A residential landlord has the statutory duty to maintain the rented premises in a habitable condition at all times. Similarly, a tenant has the statutory duty to refrain from damaging the premises and advising the landlord of adverse conditions which come about during the tenancy.[3]

To avoid disputes over who is responsible for any damage to the premises, the residential landlord and tenant complete and sign a **condition of premises addendum** before the tenant is given possession.

Before a tenant takes possession, the landlord or their manager needs to inspect the unit with the tenant. Recall this is called a *walk-through*. Together, the landlord (or resident manager) and the tenant will use a condition of premises addendum to note:

- the premises is in satisfactory condition;
- any existing damage to the premises; and
- any repairs the landlord is to make to the premises.

If the unit is furnished, the landlord and tenant complete and sign an additional form on their walk-through called a *condition of furnishings addendum*. The condition of furnishings addendum notes:

- the inventory of furnishings located in the unit;
- the current condition of the furnishings; and
- the tenant's acceptance of the furnishings. [See Form 561 in Chapter 36]

Within thirty days before the end of a residential tenancy, the condition of premises addendum is reviewed during the *pre-expiration inspectio*n to help establish tenant responsibility for excess wear and tear to the unit rented.

Pet addendum

Any provisions agreed to but not included in the boilerplate provisions of pre-printed lease or rental agreements are included in an **addendum** to the rental or lease agreement. The additional or conflicting provisions are entered on the *addendum*. The addendum is then referenced in the body of the rental or lease agreement as attached.

addendum
An attachment to a rental or lease agreement for incorporating any provision agreed to but not included in the boilerplate provisions of the agreement. [See **RPI** Form 250]

One such addendum is the *pet addendum*. If a landlord allows pets, they often:

- impose restrictions on the type or size of the pet; and
- require the landlord's written consent to keep the pet on the premises. [See **RPI** Form 551 §6.9 and Form 550 §6.9]

3 CC §§1941; 1941.2

The landlord and tenant may sign and attach a pet addendum that states:

- the type of pet and its name;
- the security deposit to be charged for the pet (but limited as part of the maximum security deposit allowed); and
- the tenant's agreement to hold the landlord harmless for any damage caused by the pet. [See **RPI** Form 563]

A landlord may not prohibit a disabled person from keeping a specially trained guide dog on the premises.[4]

Additional rules regarding pets

Additionally, a landlord who allows pets may not:

- favor declawed or devocalized animals in any advertisement;
- refuse to rent or negotiate for rent to a tenant because their pet has not been declawed or devocalized; or
- require tenants' pets to be declawed or devocalized as a condition of renting the property.[5]

Editor's note — Although landlords may not favor declawed or devocalized pets, they may still protect against property damage or noise by including a lease provision barring specific pet behavior or prohibiting pets altogether.

Waterbed addendum

Lease agreements and month-to-month rental agreements also prohibit a tenant from keeping a waterbed or other liquid-filled furnishings on the premises without the landlord's written consent. [See **RPI** Form 551 §6.9 and Form 550 §6.9]

When a tenant has a waterbed, the landlord may require the tenant to sign a **waterbed addendum**. [See **RPI** Form 564]

waterbed addendum An addendum to a rental or lease agreement setting the additional security deposit and insurance coverage the tenant will provide the landlord to keep a waterbed on the premises. [See **RPI** Form 564]

The *waterbed addendum* indicates:

- the additional security deposit the tenant will be required to provide for keeping a waterbed on the premises (in addition to the maximum security deposit allowed); and
- the tenant's agreement to maintain an insurance policy to cover potential property damage when the waterbed leaks or bursts.

Other addenda

Other addenda which may be incorporated into a residential rental or lease agreement include:

- house or building rules; and
- any *rent control* disclosures required by local rent control ordinances.

A residential landlord seeking to sell a property may also grant the tenant an option to purchase the property. [See Form 161 in Chapter 6]

4 CC §54.1(b)(5)

5 CC §1942.7

However, no portion of any option money or the rent may be applied to the purchase price. When the terms of the lease agreement or option agreement provide for any credit to be applied toward the purchase price, or to a down payment on the purchase price, the tenant has acquired an *equitable ownership* interest in the property and cannot be evicted.

This is called a **lease-option sale,** and is a masked sale of the property typically entered into in violation of all the single family residence (SFR) disclosures to the buyer/tenant, mortgage lender and county assessor. The *lease-option sale* also lacks the protective formalities and fees involved in an escrowed grant deed transfer of ownership.

Terms of residential occupancy

Residential tenants typically provide a *security deposit* to the landlord to cover the cost to clean the unit or remedy any damage caused to the unit beyond reasonable wear and tear. [See **RPI** Form 551 §2 and Form 550 §2]

In return for the use and possession of the premises, the tenant pays the landlord rent until expiration of the lease, or periodic tenancy. The tenant agrees to pay a late charge if rent is not paid on the due date, or within the established *grace period*. [See **RPI** Form 551 §4 and Form 550 §4]

Also, the number of guests the tenant may have in their unit and the period of time over which their guests may visit is limited. [See **RPI** Form 551 §5.6 and Figure 1, Form 550 §5.6]

The tenant agrees to comply with all building or project rules and regulations established by any existing *covenants, conditions and restrictions (CC&Rs)* or the landlord. [See **RPI** Form 551 §6.1 and Form 550 §6.1]

The landlord and tenant agree who will pay or how they will share the financial responsibility for the unit's utilities. Landlords of apartment buildings or complexes often retain the responsibility of providing water to the units. [See **RPI** Form 551 §6.2 and Form 550 §6.2]

In both rental and lease agreements, the tenant agrees to hold the landlord harmless from all liability for damages caused by the tenant or their guests. [See **RPI** Form 551 §7.1 and Form 550 §7.1]

Statutory rights and duties

Residential rental and lease agreements often contain provisions that restate the landlord's and tenant's statutory rights and duties.

For example, the rental agreement reiterates the landlord's statutory obligation to furnish a tenant with:

- a security deposit refund;
- a notice of the tenant's right to a joint pre-expiration inspection of the unit and delivery of an itemized statement of repairs/cleaning[6]; and

---

6 CC 1950.5(f)

- a statement of security deposit accounting and an itemization of any deductions.[7] [See **RPI** Form 551 §2.4 and Form 550 §2.4]

Also, rental and lease agreements often advise tenants of their limited statutory right to make necessary repairs to the premises and deduct the cost from the rent when the landlord fails to make the repairs the tenant has brought to the landlord's attention.[8] [See **RPI** Form 551 §6.2 and Figure 1, Form 550 d§6.2]

A rental or lease agreement prohibits a tenant from:

- using the premises for an unlawful purpose;
- creating a *nuisance*; and
- committing *waste*. [See **RPI** Form 551 §6.7, §6.8 and Form 550 §6.7, §6.8]

Even if the lease or rental agreement does not restate these statutory prohibitions, a tenant who carries on any of these prohibited activities may be evicted with a three-day written notice to quit, no alternative performance being available to the tenant.[9]

7 CC 1950.5(g)(1)
8 CC 1942
9 CCP 1161(4)

Chapter 33 Summary

The rental market is the market environment in which landlords seek tenants (and vice versa). The condition of the rental market is determined by:

- the population of tenants;
- the number of properties competing for these tenants; and
- the comparative position of the property and its amenities in relation to competing properties.

The rental market sets the amount of rent a residential landlord is able to charge on any given day.

A month-to-month rental agreement runs for an indefinite period of time. It automatically renews monthly, and on the same terms, until modified or terminated by notice. Tenants typically pay lower rents when they enter into a fixed-term lease. In stable rental markets, the longer the lease, the lower the rent.

On locating a prospective tenant for a residential unit, the landlord establishes the prospect's creditworthiness by requiring the tenant to fill out a credit application.

Every landlord has a duty to ensure the housing they rent remains safe and sanitary. Additionally, a landlord has a duty to protect their tenants from foreseeable dangers.

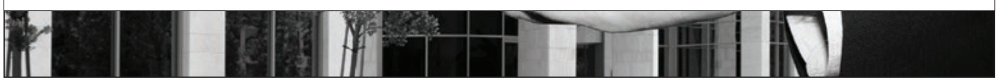
Any provisions agreed to but not included in the boilerplate provisions of pre-printed lease or rental agreements maybe included in an addendum to the rental or lease agreement, such as a:

- pet addendum;
- non-smoking addendum; and
- waterbed addendum.

Chapter 33 Key Terms

Chapter 34

The sales price



Learning Objectives

After reading this chapter, you will be able to:

- use a seller's net sheet to estimate the amount of net proceeds a seller is likely to receive from the price received on the sale of their residential or commercial income property;
- understand how income and expense data comprise a rental property's net operating income (NOI) and are used to establish value;
- estimate a rental property's probable value by examining the mathematical relationship between the sales price and NOI; and
- breakdown the sales price into basis and profit to determine the income tax consequences of a sale.

Key Terms

book value

income approach

good will

gross revenue multiplier (GRM)

net sales proceeds

operating expenses

Different views, different aspects

Prudent brokers and listing agents always timely advise sellers on the amount of **net proceeds** they may anticipate receiving from the sales price on closing. Agents first do so at the listing stage by preparing and reviewing a **seller's net sheet**, the sales price being the listing price. The preparation is later repeated to analyze the price set in each purchase agreement offer considered by the seller, and on a reduction in the listing price.

The agent's advice involves use of a seller's net sheet to estimate the dollar amount of the seller's **net equity** in the property as a disclosure of the net proceeds likely to be received on a particular sales price. [See **RPI** Form 310]

net sales proceeds
The seller's receipts on closing a sale of their property after all costs of the sale and mortgage payoffs have been deducted from the gross proceeds.

But what about any profit (or loss) on a sale? **Profit and loss** are always different in amounts from the net proceeds on a sale, but are also a breakdown of the sales price. Tax wise, profit or loss data is important, maybe critical to a seller's analysis of the financial consequences of a sale. A sale at a profit, while sought, produces a tax liability for the seller unless exempt, excluded, or deferred. Sellers frequently believe their profit, the amount they will pay taxes on, is somehow related to the amount of net proceeds they receive on a sale.

Thus, a belief commonly held by sellers is that their equity equals their profit. It does not. The differences become more distorted when the seller has refinanced the property and increased the debt encumbering the property — since the equity (and net proceeds) shrunk but the profits did not.

The reason: the seller's **equity** in a property and their **profit** on a sale are each derived from different data except for the price. Respectively, the mortgage debt and the seller's cost basis. On a sale, they are never the same amount– although the price received is common to both.

Before breaking down the **sales price** into its components for these various purposes, several economic fundamentals of real estate ownership must be differentiated and understood:

- *capital investment* made to acquire and improve the property (cash contributions, funds from loans, and cost basis carried forward from a sale in a prior exchange);
- *annual operating data* generated by rents and expenses of ongoing ownership; and
- *tax consequences* of buying, ownership operations and selling.

A property's sales price, also related to its *market value,* is the only term common to all economic analysis regarding ownership of a home, business-use property and rental real estate (residential or commercial).

Homebuyers tend to be less inquisitive about acquisition costs (known to agents), operating expenses (known to sellers) and income taxes (known to brokers) than are buyers of business or investment real estate. [See Form 306 accompanying this chapter; see **RPI** Form 311]

Capital aspects of the sales price

Any buyer interested in the property can quickly break down the published sales price into its **debt** and **equity**. It is the seller's equity a buyer is cashing out, no matter how the buyer might be funding their purchase.

The **amount of debt** encumbering a property is deducted from the sales price to determine the seller's *gross equity* in the property. However, debt is never used to determine the seller's profit on a sale (except for short sales). [See Figure 1]

Form 306

Property Expense Report

PROPERTY EXPENSE PROFILE

Prepared by: Agent ______________ **Phone** ______________
Broker ______________ **Email** ______________

NOTE: This form is used by an owner and their sales or leasing agent when preparing a marketing package for the sale of a one-to-four unit residential property or the lease of any type property and disclosing the property's operating costs, to prepare a worksheet to be handed to prospective buyers and tenants for their review of the monthly property operating costs and deposits they will likely incur on taking possession of the property.

DATE: __________, 20_____, at ______________________, California.

1. **PROPERTY TYPE** ______________
   - 1.1 Location ______________
   - 1.2 Expense figures are estimates reflecting:
     - a. ☐ current expenses of occupancy/ownership.
     - b. ☐ forecast of anticipated expenses of occupancy.
2. **MONTHLY OPERATING EXPENSES:**
   - 2.1 Electricity . . . . . $__________
   - 2.2 Gas . . . . . $__________
   - 2.3 Water . . . . . $__________
   - 2.4 TV (cable/satellite) . . . . . $__________
   - 2.5 Phone . . . . . $__________
   - 2.6 Internet . . . . . $__________
   - 2.7 Trash . . . . . $__________
   - 2.8 Sewage . . . . . $__________
   - 2.9 General obligation bonds . . . . . $__________
   - 2.10 Lawn/Gardening . . . . . $__________
   - 2.11 Maid/Housekeeping . . . . . $__________
   - 2.12 Pool/Spa . . . . . $__________
   - 2.13 Homeowners' Association (HOA) . . . . . $__________
   - 2.14 Maintenance and repair . . . . . $__________
   - 2.15 Property management services . . . . . $__________
   - 2.16 Insurance ______________ . . . . . $__________
   - 2.17 Taxes ______________ . . . . . $__________
   - 2.18 Other ______________ . . . . . $__________
   - 2.19 **Total Operating Expenses** . . . . . $__________
   - 2.20 Monthly Loan Payment (Principal and Interest). . . . . $__________
   - 2.21 Total Monthly Expenses . . . . . $__________
3. **DEPOSITS:**
   - 3.1 Rental security deposit . . . . . $__________
   - 3.2 Electricity deposit . . . . . $__________
   - 3.3 Water deposit . . . . . $__________
   - 3.4 Sewage and rubbish deposit . . . . . $__________
   - 3.5 Gas service deposit . . . . . $__________
   - 3.6 Phone service deposit . . . . . $__________
   - 3.7 Other ______________ . . . . . $__________
   - 3.8 **Total Deposits** . . . . . $__________

OWNER: I have read and approve this information.
Date: __________, 20____
Owner's Name: ______________ Signature: ______________

Date Prepared: __________, 20______
Broker: ______________
CalBRE #: ______________
Agent: ______________
CalBRE #: ______________
Phone: ______________ Cell: ______________
Fax: ______________
Email: ______________

PROSPECTIVE BUYER:
I have received and read a copy of this estimate.
Date: __________, 20______
Name: ______________
Signature: ______________

FORM 306 06-17 ©2017 **RPI — Realty Publications, Inc.**, P.O. BOX 5707, RIVERSIDE, CA 92517

Also, a seller's present **capital interest** in a property is the property's price, defined as either:

- the total sum of the dollar amount of the property's current debt and equity; or
- the property's current fair market value.

The seller's capital interest in a property is not equivalent to the seller's previous capital investment in the property. The **capital investment** is the amount of a seller's initial cost basis on acquisition of a property, comprising cash and loan proceeds originally used to purchase, improve or carry the property, as well as any cost basis carried forward and offsets in an exchange, also called **book value**.

book value
The current value for accounting purposes of an asset expressed as original cost plus capital additions minus accumulated depreciation.

Any debt encumbering the property is either **assumed** by the buyer or **paid off** with funds from the buyer. Neither activity ever puts money in the hands of the seller. Funds received by escrow for payoff of an existing loan are either advanced by the buyer or obtained from purchase-assist financing arranged by the buyer.

Further, the **market value** (the sales price for the property) bears no relationship to the seller's original capital investment in the property, regardless of the amount or the time it was made. The sales price is not set as a value based on a trend line of the *historic value* or *equilibrium value* of property, much less the seller's *book value* (the depreciated cost basis remaining from the original capital investment). All these are external to the current value, noise sometimes called a **money illusion** or **veil**.

A related financial concern of a buyer is **interest** paid on mortgage debt borrowed to provide capital to purchase investment property. Interest is the **cost of capital** incurred by owners who are not solvent enough or desirous to own property "free and clear." Interest paid on the debt is not considered a capital investment expended to acquire or improve property. Further, as a cost of capital, interest is never an operating expense incurred for the care and maintenance of investment property. Thus, interest is not included in a rental property's net operating income (NOI).

However, to determine a property's reportable income or loss for the owner's annual tax filings, interest, like depreciation, is **deductible** from the property's NOI. While interest is not an operating expense incurred by the property, it is an allowable deduction for *undercapitalized owners* who, as risk takers, borrow to obtain capital to acquire property. The smaller the ratio of equity capital to price, the greater the risk of loss.

Operating data is coupled to sales price

A property's price is also set by the **capitalization** of the property's NOI based on a rate of return. This analysis is referred to as the **income approach**, complementary to the replacement and comparable approaches as methods for property valuation. The income and expense data comprising the NOI are the **fundamentals** upon which value, and thus the sales price, is established with the *income approach*.

income approach
The use of a property's rental income to set its value.

Using the income approach for an appraisal, the value of income property resets as quickly as the capitalization rate changes. On the other hand, single family residential (SFR) property values are downwardly "sticky", and thus do not respond well to recessions or changes in capitalization rates as applied by investors. For setting SFR values, brokers and appraisers look primarily to comparable sales, avoiding the more restrictive valuations produced by replacement costs or capitalization rates during times of economic prosperity.

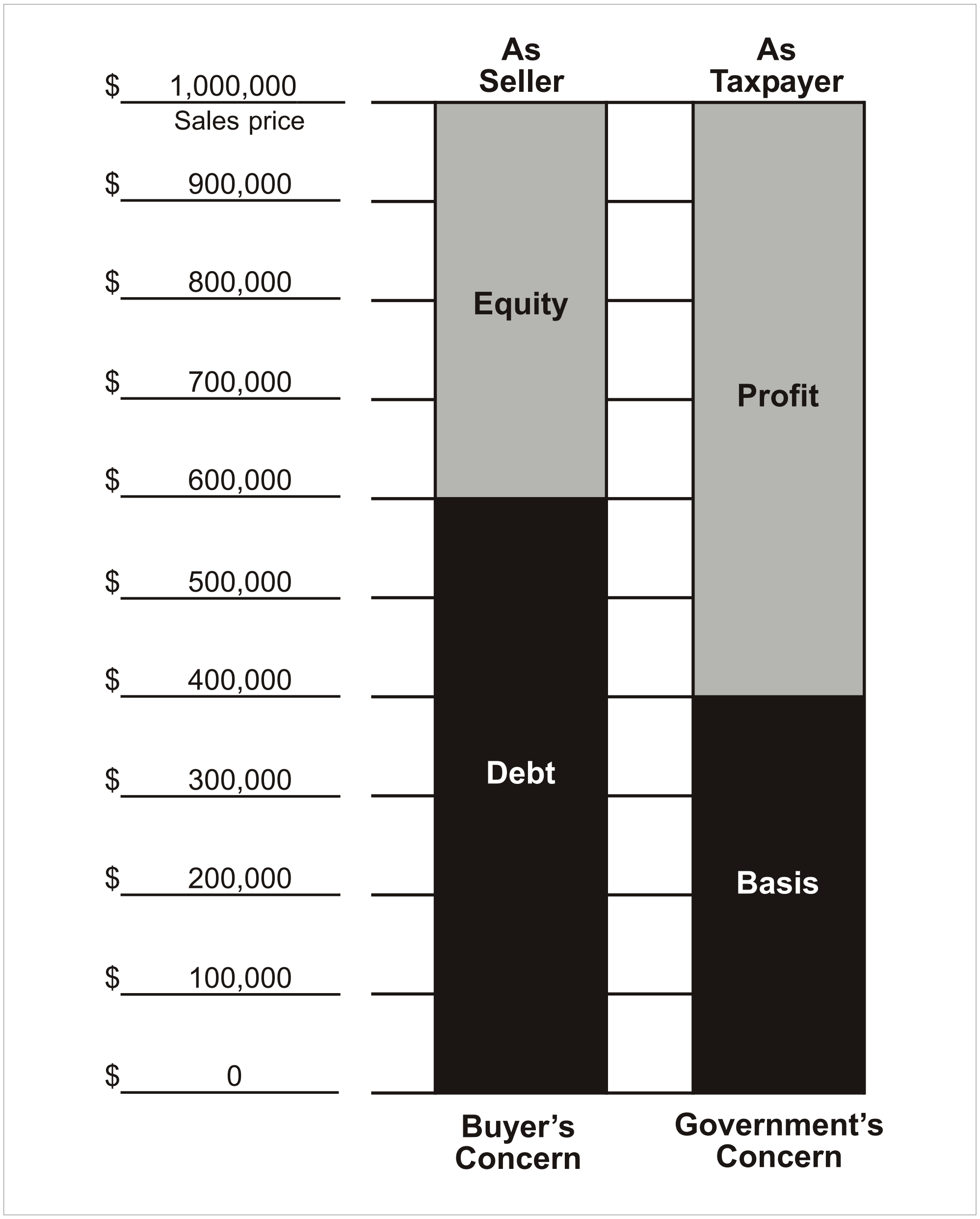


Figure 1

Owner's Position

As a quick rule-of-thumb reference to an income property's value, the mathematical relationship between the sales price and NOI produces a **multiplier** and a **rate of return** (a percentage). These "yardsticks" are used to calculate probable value and are reciprocals of one another. For example, a 9% rate of return (capitalization rate) is also a price-to-earnings ratio (multiplier) of 11. The same indicators are used in the stock market for a cursory analysis of share value, called "price-to-earnings (P/E) ratios."

Rental properties, whether residential or commercial, produce income by way of rent paid by tenants. In exchange for receiving rent, landlords incur expenses to care for and maintain the physical condition and earning power of their property, often called **good will**.

good will
The intangible image or opinion held about a property which affects its earning power.

Collectively, the rents and expenses produce the NOI of a property. In turn, the NOI gives the property a value when capitalized — the sales price.

Capital recovery, called **depreciation**, is an orderly annual recovery from rents of the portion of the owner's total capital investment allocated to improvements. Like interest deductions, depreciation deductions are unrelated to the operation of the property or the property's current sales price.

Arguably, however, an above market interest rate or a low LTV ratio on a locked-in loan (no prepayment allowed) will depress the property's value, either in the hands of the owner or on an assumption.

Each separate parcel of income-producing property has a calculable scheduled income: the total rents collectible if the property is 100% occupied, without reduction for vacancy, turnover or uncollectible rents.

Gross multipliers for preliminary valuation

gross revenue multiplier (GRM)
Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.

Also, the **sales price** of a residential or commercial rental is often roughly stated by use of a **gross revenue multiplier (GRM)** or *percentage of value* based on actual income received (scheduled income less rent lost to vacancies), rough estimates of value called rules-of-thumb. As an approach to pricing a property, this determination of price is preliminary and superficial —but it is a way for buyers to begin the selection of possibly qualifying properties.

Historically, the scheduled monthly rents for a residential rental, when viewed as a **percentage of value**, are said to represent about 1% of the sales price, an unsophisticated initial indicator of value. This *monthly income indicator* is used to approximate a reasonable price for a property which enjoys reasonable income and expenses in a market based on minimal current and expected future inflation rates.

The asking price of income property is often tested for its reasonableness by the application of a **GRM** to the annual gross rents or, as an alterative, a P/E ratio to the NOI; another multiplier which helps predict a property's value. Historically, a GRM of 7 or 8 (arguably higher, at 10 to 12, during periods of excessive asset speculation) times annual rents is used on residential units as a quick glimpse into the reasonableness of the sales price.

NOI as fundamental to valuation

As an alternative, analysis of the sales price is more properly based on the NOI a rental property is expected to produce each year in the future. The NOI is the **annual return** a property produces based on collectible rental income minus operating expenses.

Again, interest on the mortgage debt is of no concern to a buyer when evaluating property. However, the buyer financing an acquisition needs to do so at interest rates no greater than the buyer's capitalization rate — their rate of return as the ceiling for interest paid on mortgage financing.

The annual **rate of return** — the **capitalization (cap) rate** — sought by a buyer is applied to the NOI to produce a sales price the buyer will pay for the property — its value to a buyer before adjustments for the cost of financing the price.

The *cap rate* applied to the NOI comprises an anticipated future consumer inflation rate (CPI) of, say, 2% annually, a recovery of the seller's capital investment of, for example, 3% annually, and a "real" (after inflation) **rate of return** for the buyer of 3% to 4% annually. [See Chapter 4]

Tax components in the sales price

Taxwise, the **sales price** is broken down into **basis** and **profit** to determine the income tax consequences of a sale. The short formula for profit is: price minus basis equals profit.

However, a tax analysis of the price only reflects the **consequence of a sale**. Neither a seller's remaining basis nor the profit he may seek plays any role in setting the market price a buyer may be willing to pay for a property. They do, however, play a role as a money illusion, misdirecting the seller on his opinion of value.

A seller's **basis and profit**, elements of state and federal tax reporting, are of no concern to a buyer. A buyer can never acquire a seller's basis, and a seller's basis does not in any way contribute to or help a buyer establish a property's value.

Also, a seller's remaining cost basis in a property is never equal to the amount remaining unpaid on the loans encumbering the property. Likewise, deducting basis from the sales price sets the seller's profit; basis never sets the equity acquired by the buyer since equity is the result of price minus mortgage debt.

When a buyer acquires property, a **cost basis**, also called book value, is established as a total of all the expenditures related to the purchase of the property and the improvements necessary to use it or attract tenants, called **placing the property in service**. During the period of ownership prior to resale, a property's cost basis is adjusted periodically due to depreciation (capital recovery), hazard losses and further improvements.

Tax wise, the cost basis remaining at the time of resale is deducted from the net sales price to determine whether a profit or loss has been **realized** by the seller. Whether the price realized is taxed – *recognized* – is a separate issue.

A buyer's payment of the **purchase price** is his capital contribution. The price paid consists of any cash contributed to fund the price and transactional costs, the principal balance of existing trust deed loans assumed, net proceeds from new loans and the fair market value of the equity in other property (except §1031 like-kind real estate) used to purchase or improve the property acquired, collectively called costs of acquisition.

Editor's note — If the purchase price paid includes an equity from §1031 like-kind real estate, the basis in the property purchased will include the remaining cost basis in the property sold (not its sales price), adjusted for additional contributions or the withdrawal of money (cash boot) and differences in the amount of existing debt (mortgage boot) on the properties.

Adjustments to value

operating expenses
The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

Additional improvements do contribute to a property's value when they cause rents to be increased, sometimes called **sweat equity**. Thus, the expenditures for the **cost of improvements** are added to the basis in the property. Conversely, expenditures for the upkeep, maintenance, repair and operations of the property are **operating expenses** deducted from rental income. While operating expenses add nothing to the cost basis in the property, they do maintain — and often increase — the amount of the property's rents, and thus its value and sales price.

Net cash proceeds from **refinancing** or equity financing which are not used to purchase or improve property do not contribute to the cost basis (or affect the property's value). While any financing affects a property's equity, the assumption (take-over) of existing financing and the investment of funds from the proceeds of a purchase-assist or construction loan will make up part of the buyer's cost basis on acquisition.

The **depreciation allowance** represents an annual return to an owner (from rents) of a percentage of his total capital contribution allocated to improvements on the property. Accordingly, the **cost basis**, being the total of all capital contributions, is reduced each year by the **deduction** of the annual depreciation allowance from the NOI.

Assuming the property will receive future maintenance, none of the depreciation taken in anticipation of deterioration or obsolescence weighs in when setting the sales price. Again, tax accounting and book value do not play a part in the calculation of a property's market value (sales price).

On resale of a property, the seller's initial tax concern is the amount of profit that exists in the sales price. The structuring of the terms for payment of the sales price or reinvestment determines whether the profit in the sales price will be taxed, and if taxed, when the seller will pay those taxes.

Chapter 34 Summary

A seller's net sheet is used to estimate the dollar amount of the seller's net equity in the property as a disclosure of the net proceeds likely to be received on a particular sales price.

The seller's equity in a property and their profit on a sale are each derived from different data, respectively — the debt and the basis. On a sale, they are never the same amount although the price received is common to both.

Tax wise, the sales price is broken down into basis and profit to determine the income tax consequences of a sale.

The amount of debt encumbering a property is deducted from the sales price to determine the seller's gross equity in the property. However, debt is never used to determine the seller's profit on a sale (except for short sales).

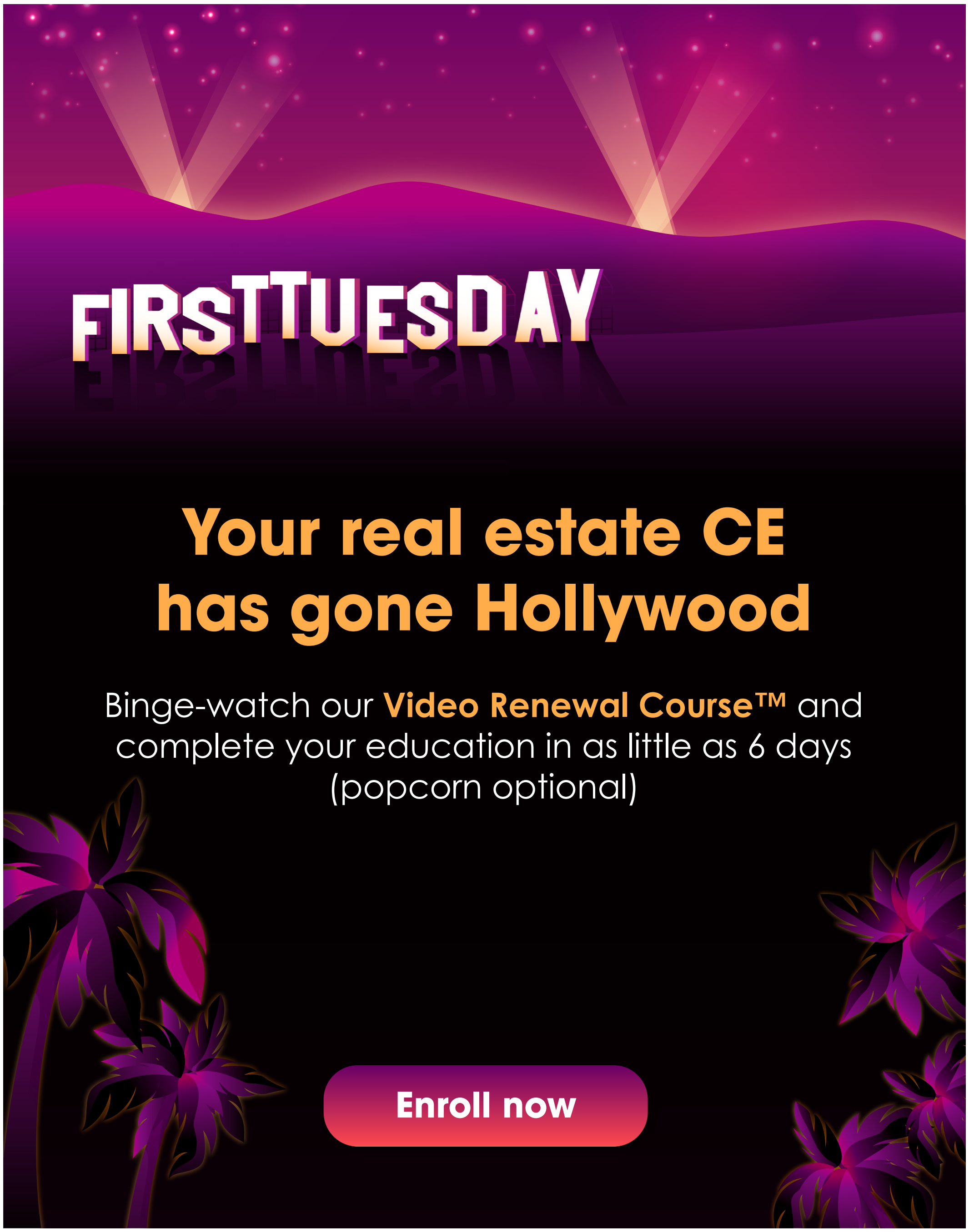
Rental properties, whether residential or commercial, produce income by way of rent paid by tenants. In exchange for receiving rent, landlords incur expenses to care for and maintain the physical condition and earning power of their property, often called good will.

Collectively, the rents and expenses produce the net operating income (NOI) of a property. In turn, the NOI gives the property a value when capitalized — the sales price.

Tax wise, the cost basis remaining at the time of resale is deducted from the net sales price to determine whether a profit or loss has been realized by the seller.

On the resale of a property, the seller's initial tax concern is the amount of profit that exists in the sales price. The structuring of the terms for payment of the sales price or reinvestment determines whether the profit in the sales price will be taxed, and if taxed, when the seller will pay those taxes.

Chapter 34 Key Terms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Chapter 35

Income tax categories

Learning Objectives

After reading this chapter, you will be able to:

- distinguish the three categories of taxable income based on the type and use of the real estate generating the income, profit or loss;
- estimate an owner's annual income tax liability resulting from the operations of a rental property; and
- understand the activities which constitute active management of a rental property needed for the owner to classify its income or loss as passive income.

Key Terms

adjusted gross income (AGI)

material participant

passive income category

portfolio income category

trade or business income category

The many types of income

A central tax concept, requisite to understanding an owner's annual reporting of real estate operations, financing, and sales, is the existence of three income categories, sometimes referred to as **income pots**. The category, or pot, into which a property falls controls the accounting and the reporting of the property's income, profit and loss. Collectively, these earnings are called **income** by the Internal Revenue Service (IRS). [See Figure 1]

When an owner of real estate, their broker, or their accountant prepares an estimate of the owner's annual income tax liability, the owner's total income, profits and losses from all sources are first classified as belonging in one of the **three income categories**:

- professional trade or owner-operated business opportunities, called the **trade or business income category,** including any **real estate owned and used** to house the owner's trade or business;[1]

1 Internal Revenue Code §469(c)(6)

passive income category
Profits and losses from rental real estate operations and sales, and from non-owner-operated businesses.

- rental real estate and non-owner-operated business opportunities, called the **passive income category**;[2] and
- investments, called the **portfolio income category.**[3]

Classifications for the different categories focus on the **type and use** of the real estate generating the income, profit or loss. The vesting employed by the individual owner or co-owners to hold title is not relevant, unless a C corporation, taxable trust or the estate of a deceased person is the owner and operator since they are taxed separately from their owners (shareholders or beneficiaries).

For example, the ownership of rental properties (residential or commercial when tenant occupancies exceed 30 days, on average) by a limited liability company (LLC) is not a trade or business of the LLC or its owners, called **members**. Each member of the LLC reports their pro-rata share of the income, profit or loss from the rental operation (whether it is residential or commercial) as *passive category income*.

Taxwise, an LLC is treated as a partnership unless it elects to be taxed as a C Corporation. Thus, as in any partnership, income is passed through to its members who are liable for any income tax.[4]

Conversely, **property management services** rendered by an individual unincorporated broker on behalf of rental owners constitute a *trade or business category* activity for the broker.

Mutually exclusive income categories

The three income categories are mutually exclusive of one another. Simply put, losses from one category cannot be used — **commingled** — to **directly offset income** or profit existing within another category. Each category's income, expenses and deductions are first tallied separately to establish the end-of-year income, profit or loss within the category.

adjusted gross income (AGI)
The total of the taxpayer's reportable income and losses from all three income categories.

When a reportable end-of-year income or profit exists within any category, it is added to the owner's **adjusted gross income (AGI)**. However, when the end-of-year result is a *reportable loss*, only the amount of loss in the business category is automatically subtracted from the AGI without limitation.

Also, each category has different internal accounting rules. For instance, the operating income or loss from each assessor-identified parcel of *rental (passive) category* property owned by the taxpayer is treated and accounted for separately from that of every other parcel of rental property the taxpayer owns (unless in the same complex), called **tracking**.

Tracking maintains the sequestration of suspended losses as available only to offset future income or profit on the property generating the operating loss. No such **tracking requirement** exists within the business income category or the portfolio income category.

2 IRC §469(c)(1)
3 Revenue Regulations §1.469-2T(c)(3)
4 IRC §701

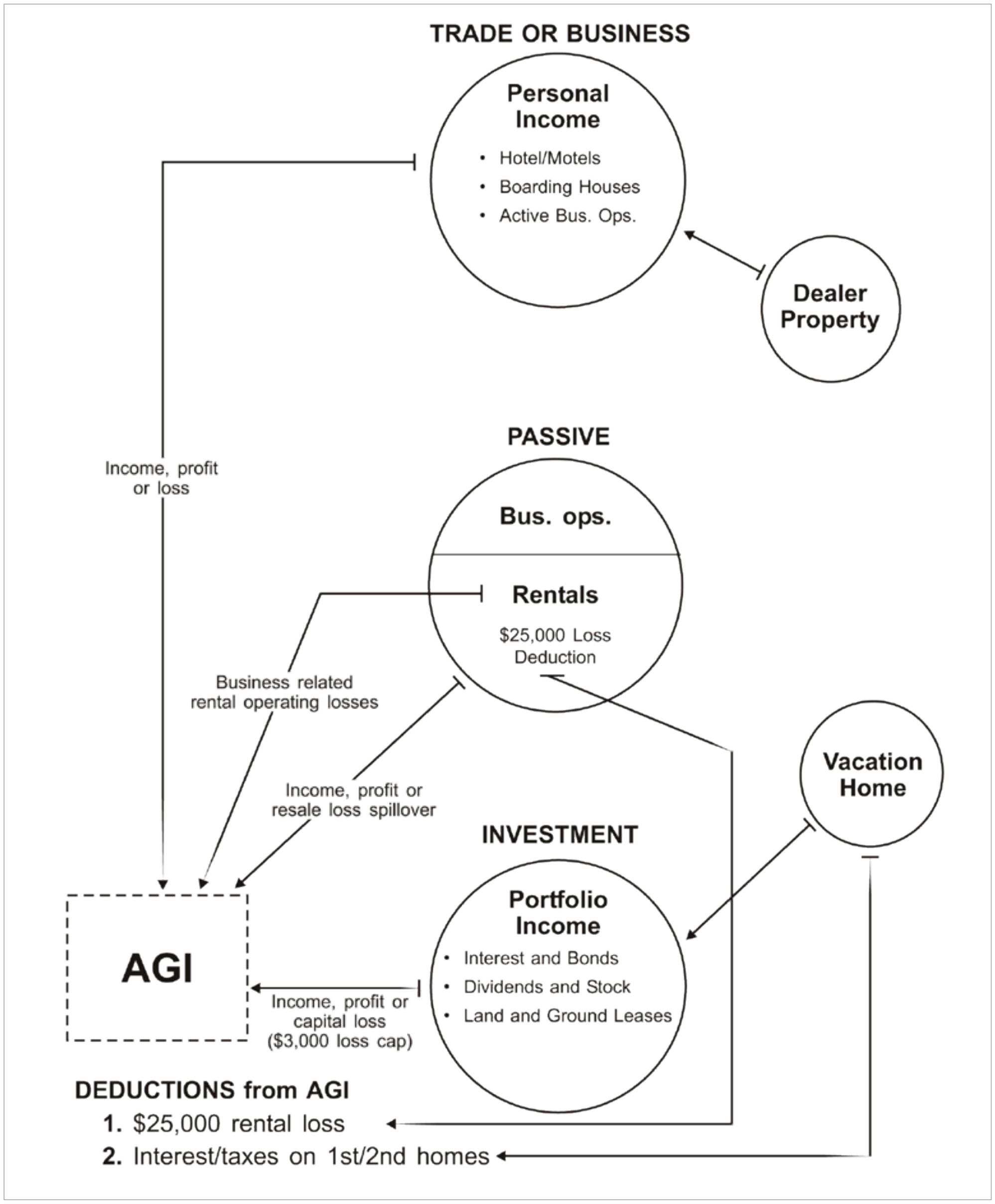


Figure 1

Adjusted Gross Income (AGI) Categories

Another accounting requirement unique to the passive income category is that any annual *operating loss* on a rental property be carried forward into future tax years, called a **suspended loss**. In future years, the suspended rental operating loss is then deductible from reportable income or profit on the operations or sale of the property that generated the loss. When at the time of a sale the suspended loss exceeds the profit, any remaining loss spills over to reduce the AGI.

When passive losses offset other income

Further, **rental operating losses** cannot be directly used to offset income or profit in other categories, but are allowed when the owner qualifies to write off the loss as either:

- a real estate related business adjustment to their AGI; or
- the $25,000 rental loss deduction from their AGI.

In contrast, **portfolio investments**, such as land and management-free income property with fully net leases, are batched together to calculate the annual income, profit and loss from all properties within the portfolio income category. Portfolio assets are not subject to the passive category tracking of losses by asset.

Thus, when an annual operating loss is incurred within the category, it is *carried forward* to offset income or profits in future years from any source within the portfolio category.

As for indirect offsetting between the categories, the end-of-year income, profits and allowable losses are first totaled within each category. The totals from each of the categories are then brought together (subject to limitations on passive or portfolio losses) to establish the owner's AGI.

For the owner or broker to analyze and estimate the owner's annual **income tax liability** resulting from a sale or purchase of real estate, two major accounting components are first estimated:

- the owner's AGI, derived from any net annual operating income and sales profits generated within each income category, less any end-of-year loss within the trade or business category, loss on the sale of rentals, rental operating losses allowed for owners involved in real estate related businesses, and capital losses up to $3,000 from the portfolio category; and
- the owner's taxable income, which is the AGI less personal deductions, exemptions and any $25,000 rental property operating loss deduction.

Owner's trade and business category

trade or business income
Income, profits and losses from the taxpayer's trade or owner-operated business, resale inventory and real estate used in the trade or business.

Trade or business income and loss includes:

- earnings from the individual's trade or business and use of their real estate in the conduct of the trade or business, including ordinary income from the sale of property held as inventory by subdividers, builders and dealers;[5]
- income and losses from the individual's business opportunity (sole ownership, partnership, LLC or S corporation) and the real estate owned and used in the business, when the individual is a *material participant* in the management of the business;[6] and
- income and losses from the individual's owner-operated hotel, motel or inn operations (sole ownership, partnership, LLC or S corporation) with average occupancies of 30 days or less, when the individual is a *material participant* in management.[7]

Rentals and passive category

An individual's real estate *income property operations* (excluding business category hotels, motels, inns and portfolio income from management-free fully net leased real estate), referred to by the IRS as **rental income**, are accounted for within the passive income category.

5 IRC §469(c)(6)(A)
6 IRC §469(c)(1)
7 Rev. Regs. §1.469-1T(e)(3)(ii)(B)

This includes:

- rents, expenses, interest, depreciation from annual operations and profit and losses from sales, of residential and commercial rental real estate that has an average occupancy of more than 30 days and requires **active management** under rental or lease agreements; and
- income or losses from business opportunities owned or co-owned but not operated by the individual (no material participation in its management, called **passive ownership**).[8]

Income received from rental operations is often referred to as *passive income*. Ironically, for income property to be a rental, and thus reported within the passive income category, the owner must be committed to the **active management** of the property.

To be considered involved in the *active management* of a property, the landlord must have some legal responsibility to care for the property under their lease(s) or rental agreement(s). When the landlord has no contractual responsibility for the care and maintenance of the property, the income property becomes a *portfolio category property*, not a passive category rental property, due to the lack of management requirements imposed on the ownership or their agents.

material participant
A rental property owner who participates in real estate rental operations or a real estate profession on a regular, continuous and substantial basis.

For example, this shift to portfolio income occurs under a management-free, fully net lease situation since the tenant contracts to care for and maintain the property and structures.

portfolio income category
Unearned income from interest on investments in bonds, savings, stocks and mortgage notes, and income, profits and losses from management-free income property.

Often an owner rises to the highest level of activity in rental operations or in a real estate related profession — called a **material participant** — and described as an owner/operator of rentals, a licensee providing real estate brokerage services or a real estate developer. As a *material participant*, the owner qualifies to write off all rental operating losses for the year against income from all categories to reduce their AGI and, in turn, their taxable income.[9]

Investments held for profit — portfolio category

Investment income, profits and losses taken by an individual, referred to as **portfolio income** by the IRS, include:

- **interest earned** on bonds, savings accounts and secured or unsecured notes (such as carryback mortgages, interest on delayed §1031 reinvestment funds, and mortgage lending);
- annuities, dividends and royalties from personal property investments (stocks, bonds, commodities); and
- income, profits and losses from the ownership of land subject to ground leases, management-free net leased real estate and unimproved land held for profit on resale.[10]

8 IRC §469(c)
9 IRC §469(c)(7)
10 IRC §469(e)(1)(A)

Chapter 35 Summary

When determining an owner's annual income tax liability, the owner's total income, profits and losses from all sources are classified as belonging in one of the three income categories:

- professional trade or owner-operated business opportunities, called the trade or business income category, including any real estate owned and used to house the owner's trade or business;
- rental real estate and non-owner-operated business opportunities, called the passive income category; and
- investments, called the portfolio income category.

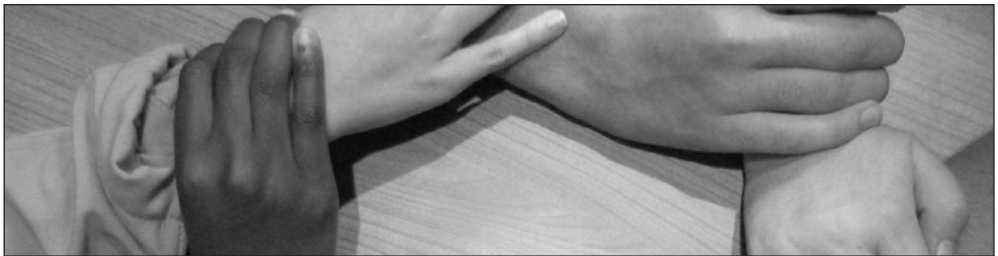
Classifications for the different categories focus on the type and use of the real estate generating the income, profit or loss.

The three income categories are mutually exclusive of one another. Losses from one category cannot be used to directly offset income or profit existing within another category. Each category's income, expenses and deductions are tallied separately to establish the end-of-year income, profit or loss within the category. Further, each category has different internal accounting rules.

Income received from rental operations is often referred to as passive income. For income property to be a rental, and thus reported within the passive income category, the owner must be committed to the active management of the property. To be considered involved in the active management of a property, the landlord must have some legal responsibility to care for the property under the lease(s) or rental agreement(s).

An owner who rises to the highest level of activity in rental operations or in a real estate related profession, called a material participant, qualifies to write off all rental operating losses for the year against income from all categories to reduce their AGI and, in turn, their taxable income.

Chapter 35 Key Terms



Chapter 36

A chronology for syndication

Learning Objectives

After reading this chapter, you will be able to:

- explain the activities of a syndicator needed to form a group investment structured as a limited liability company (LLC) for the acquisition and ownership of an income-producing property; and
- appreciate the steps taken by a syndicator to locate property, solicit investors, form an LLC and acquire income producing real estate.

Key Terms

syndication **syndicator**

Guidelines for forming a group

Consider a real estate broker or agent who gathers investors into a group for the purpose of buying, operating and ultimately selling income-producing property. Here, the broker is involved in a process known as **syndication** or **syndicate brokerage**.

syndication
The activity of a syndicator to bring together a group of investors in co-ownership formed as a limited liability company to fund the purchase of a property, and perform property management during ownership and eventually resell the property.

A broker who arranges the acquisition of income-producing property, organizes the group of investors and will oversee property management is known as a **syndicator** or **manager**.

Unlike sophisticated real estate investors who tend to operate alone, individuals who join together in *syndication programs* are generally uninformed and inexperienced about:

- the legal aspects and accounting of co-ownership;
- the economic factors that influence the movement of real estate rents and values;
- the responsibilities of property management; and
- the compensation a syndicator or manager is entitled to receive.

syndicator
An individual who solicits cash contributions from investors to fund a limited liability company which will acquire real estate for investment purposes.

The broker acting as a *syndicator*, sometimes called **syndicate brokerage**, undertakes **agency duties** to:

- conduct a competent due diligence investigation into the property to be acquired; and
- fully inform each individual prospective investor of all aspects of the property and the investment program that might influence a prudent investor's decision whether or not to contribute funds for its acquisition.

Checklist of syndicator activities

When a broker or agent decides to solicit investors and form a *limited liability company (LLC)* in a syndication effort to acquire ownership and operate an income-producing property, they need to consider all the steps set out in the following **chronological list of activities**:

- Research available residential or commercial rental properties and select one to be investigated and confirmed as suitable to purchase. [See **RPI** Form 185 and 279]

  Editor's note — Non-income-producing property acquired by an LLC will require modification of the documents in this material.
- Analyze the property selected, including its physical condition, the economic risks, environmental and natural hazards of the property's location, personal security, title conditions and property operating data. [See **RPI** Form 304, 314, 321, 324 and 352; see the **RPI** Income Property Brokerage suite of forms; see Chapter 9 and 10]
- Contract to purchase the property in the name of the syndicator under a(n):
  - *purchase agreement* [See **RPI** Form 159];
  - *option to purchase* [See **RPI** Form 161 and 161-1]; or
  - *escrow instructions* with a vesting provision allowing the syndicator to assign their right to purchase the selected property to the LLC. [See **RPI** Form 401]
- Open escrow in the name of the syndicator, not the LLC, as the buyer. Prior to closing and after the LLC has been formed, the syndicator will assign their right to buy the property to the LLC. [See **RPI** Form 161 and 401]
- Complete a **due diligence analysis** and confirm the seller's disclosures regarding the condition of the property's improvements, operations, location and title.
- Apply for new financing or an assumption of the existing financing as called for in the purchase agreement. [See **RPI** Form 159]
- Review plans for the formation and management of an LLC entity with competent legal and accounting advisors.
- Prepare the *investment circular (IC), subscription agreement, LLC-1 (Articles of Organization)* and *LLC operating agreement*, along with their exhibits and addenda, naming the syndicator as manager of the LLC. [See **RPI** Form 371 and 372]

Checklist of syndicator activities, cont'd

- Deliver copies of the IC to prospective investors to solicit them to become members and fund the LLC so escrow can close and the property be acquired.
- Obtain the signature of each investor on a separate subscription agreement and the signature page of the LLC operating agreement, and receipt of their funds by the syndicator or escrow. [See **RPI** Form 373]
- Enter into a *property management agreement* to employ a syndicator to manage the day-to-day operations of the property. This agreement needs to be signed by each investor who became a member of the LLC. [See **RPI** Form 590]
- Arrange mortgage financing and sign loan documents for an assumption of an existing loan(s) or the origination of a purchase-assist loan, either in the name of the syndicator or on behalf of the LLC, as demanded by the lender.
- File the *LLC-1 Articles of Organization*, prepared and signed by the syndicator, with the California Secretary of State.
- Assign the syndicator's right to purchase the property to the LLC in an amendment to the escrow instructions, and vest title to the property in the name of the LLC on closing. [See **RPI** Form 370 or 401-2]
- Fund the purchase price and closing costs from cash contributions received from the members of the LLC and mortgage financing.
- Close escrow and take possession of the property.
- Send copies of all closing documents to each member of the LLC.
- File an LLC-12 with the Secretary of State within 90 days after filing the LLC-1 and biennially thereafter, and identify the *manager* as the agent for service.
- Operate the property on behalf of the LLC during the LLC's ownership of the property and distribute earnings to the members.

Resale of the property

Lastly, the syndicator will resell the property when its ownership no longer meets the objectives of the investment group, or when the initial goal was to sell or exchange the property after a period of time.

The manager will negotiate the sale and the net proceeds to be distributed to the members on closing.

All these activities will be discussed in greater detail in later chapters of this material.

Chapter 36 Summary

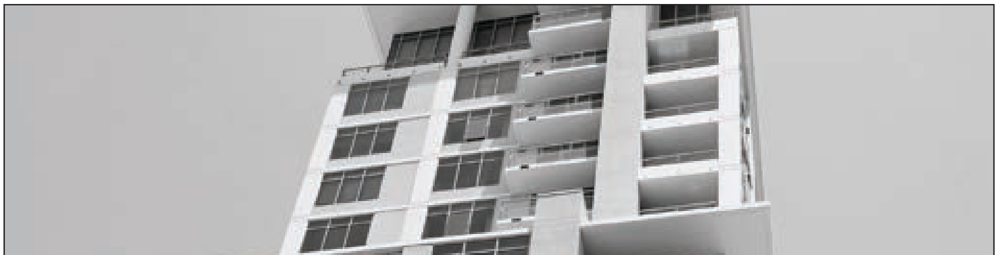
The process of syndication occurs when a real estate broker or agent gathers a group of investors together to form a limited liability company (LLC) for the purpose of buying, operating and ultimately selling income-producing property. A broker who arranges the acquisition of income-producing property and organizes the group of investors is known as a syndicator or manager.

A broker acting as a syndicator undertakes the agency duty of investigating and fully informing each individual prospective investor of all aspects of the property and the investment program that might influence a prudent investor's decision to contribute funds.

When forming an LLC for the acquisition and ownership of an income-producing property, the syndicator performs numerous activities, including but not limited to:

- researching available properties and selecting one to be investigated as suitable for purchase;
- analyzing the property selected, including its physical condition, the economic risks, environmental and natural hazards of the property's location, personal security, title conditions and property operating data;
- contracting to purchase the property in the name of the syndicator;
- opening escrow in the name of the syndicator as the buyer then assigning their right to buy the property to the LLC; and
- reviewing plans for the formation and management of an LLC with competent legal and accounting advisors, and completing the required documents for formation.

Chapter 36 Key Terms



Chapter 37

The syndicator's professional services

Learning Objectives

After reading this chapter, you will be able to:

- understand how a broker license issued by the California Department of Real Estate (DRE) lends credibility and stature to a syndicator's investment program;
- effectively use a real estate broker's license to render professional services for a fee as a syndicator and manager of real estate; and
- appreciate the need for personal accomplishments and credentials a syndicator needs to possess to exhibit to investors a greater probability of success in an investment.

Key Terms

errors and omissions (E&O) insurance

investment circular (IC)

operating agreement

Licensing as a legitimizing force

Consider a licensed real estate broker who has been earning a decent living from the fees earned handling the sale of income-producing properties and the purchase of developable land for builders.

However, the broker's **net wealth** is minimal, consisting only of their home, two cars and a duplex. The broker acquired these assets with little or no down payment. Thus, all the broker's assets are encumbered with manageable debt. The broker has an excellent credit rating, maintains a minimal amount of consumer debt and has modest cash reserves.

The broker is concerned about building the future *net worth* needed to attain a better quality of living and a higher civic status. To accomplish these personal financial objectives, the broker needs to supplement the rate of fees presently earned. The broker determines this can be done by acquiring ownership of income-producing properties.

Being constantly exposed to income properties that come onto the market for sale, the broker begins to consider the possibility of owning and operating some of these properties for the broker's own account. To achieve this goal, the broker will initially need to co-own any income property with a group of investors who will put up all the cash needed to cover the costs of acquisition.

The broker is very experienced at locating property, conducting due diligence investigations and contracting for the acquisition of property. Rather than receiving a brokerage fee for locating and working up a package on a property for a client, the broker intends to act as a principal and acquire a percentage of ownership *in* a property in co-ownership with one or more investors who will provide all the cash.

Also, as an economic necessity, the investors will contribute enough funds to pay a modest front-end fee for the broker's efforts spent soliciting the investors and forming a limited liability company (LLC) to own the property.

The brokers acts as property manager

The broker will be designated as the manager — chief operating officer (CEO) — of the LLC. After acquiring a property vested in the name of the LLC, the broker will be the **property manager**. As the *property manager*, the broker will:

- oversee on-site resident managers;
- coordinate the solicitation of tenants;
- negotiate leasing arrangements; and
- arrange for the care and maintenance required to protect and improve the value of the property.

The amount of the management fee will be based on a percentage of the **gross rental income** produced by the property. Thus, the broker has an incentive to attain the highest possible rents for the property. The greater the amount of rents, the greater the amount of management fees the broker will receive (and the more valuable the property will be).

As a co-owner, the broker will share in the **spendable income** produced by the property. If everything goes as planned, the value of the broker's **percentage ownership interest** will likely inflate and appreciate over time, similar to the interests of the cash investors.

During the tenure of the LLC's ownership of the property, the broker will receive fees for *brokerage services* rendered if the property is refinanced or sold, or if a co-owner decides to resell their fractional ownership interest. All these activities are fee-generating events.

Syndicating to build net worth

With this plan in place, the broker sees a way to accomplish both of their personal objectives in one activity: syndication for the acquisition of an ownership interest in income property with cash investors. Through the syndication of income-producing property, the broker will correspondingly build net worth and receive additional flows of income from fees for management services and distributions of spendable income.

Is it permissible for a broker, acting as a syndicator, to receive contingency or percentage-based fees for rendering real estate brokerage services to a group of co-owners when the broker becomes a co-owner of the property acquired, operated and eventually sold?

Yes! To do so, the syndicator needs to hold a valid real estate broker license issued by the California Department of Real Estate (DRE). A licensed broker acting as an asset manager on behalf of the co-owners or the LLC may charge fees that are **based on a percentage** and **contingent** on:

- the rents collected;
- the price received on a resale of the property; or
- the amount of any mortgage arranged.

As a co-owner who is a broker, the syndicator is not restricted to a salary or a fixed dollar amount paid periodically as compensation without regard to the amount of rents collected, mortgage principal or resale price.[1]

However, fees the syndicator expects to receive as payment for future services need to be agreed to in the LLC **operating agreement** and a written management agreement. These agreements are entered into when forming the LLC and disclosed in the **investment circular (IC)**. Here, a separate listing agreement is not used and is not needed for the syndicator to be entitled to fees. [See **RPI** Form 372]

operating agreement
A form used by syndicators when setting up a limited liability company (LLC) to establish the procedures for operating the LLC and the rights and duties of its members. [See **RPI** Form 372]

investment circular (IC)
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **RPI** Form 371]

Further, any compensation the broker will receive, whether acting as a principal in ownership or as a broker rendering services for the LLC, needs to be disclosed in the *IC* prepared to solicit investors. [See **RPI** Form 371]

An unlicensed person may manage the investment property for the co-owners with compensation based on a fixed monthly fee or salary. However, the *unlicensed manager* may not receive **incentive-based compensation**, such as a percentage-based fee tied to:

- the amount of rent collected;
- an occupancy rate;
- minimum spendable income; or
- other production-based formula.[2]

1 California Business and Professions Code §10131
2 Calif. Bus & P C §10133(a)(1)

The advantages of being licensed

A real estate broker syndicating group investments needs to analyze the long-term role syndication will play in their professional career. For brokers, syndication is a source of **mixed income**:

- part of their income will come from the wealth in ownership of fractional interests in real estate; and
- part of their income will come from fees for brokerage services rendered.

The broker negotiating the purchase of property and soliciting investors experiences an indirect benefit for having earned a license and the right to conduct business as a broker. They will be viewed by investors as having achieved the necessary credentials to make them capable of managing syndication.

Experience as a licensed professional

Members of the public who have accumulated cash savings and are considering investing generally understand that a person licensed as a broker has a high degree of experience in the real estate business and proven longevity. They presume the broker has attained an advanced level of technical training and education to qualify for a broker license — as they have.

When a prospective investor is solicited by a broker to participate in the co-ownership of an income-producing property, the investor also presumes the broker as a **licensed professional** has experience working with fellow licensees:

- locating property;
- negotiating purchase agreements;
- arranging financing and leasing; and
- managing property.

These points of expertise are frequently taken for granted as being part of the qualifications requisite to becoming a licensed broker. More germane, they are critical to successful syndication.

The silent power of a license

A broker has something tangible to lose if they are incompetent — or worse — fraudulent in their representation of the values and attributes of property.

A broker's exposure to loss of their license for improper conduct greatly reduces the investors' risk of the **moral hazard** of investing with a syndicator who does not invest their own cash and would not otherwise suffer if the investment fails for known, readily discoverable or avoidable defects.

errors and omissions (E&O) insurance
An insurance policy protecting brokers and agents from negligent conduct when acting as a licensee.

Further, prudent brokers carry professional *malpractice insurance*, called **errors and omissions (E&O) insurance**. Coverage for negligent misrepresentations, available to licensed broker syndicators, further places the investors' mind at ease about the integrity of the syndicator and the mitigation of risk.

The *E&O* coverage provides a source of recovery beyond the investment if the investment is ill-fated for reasons of negligence in conducting:

- a due diligence investigation;
- providing management services; or
- tending to the care and protection of the property.

Holding a license also authorizes the broker to receive fees disbursed from the investors' initial contribution of capital, rental income, proceeds from the refinance or resale of the property, and for the professional services the broker provides.

Fulfilling expectations

The syndicator's task then is to live up to the **investors' expectations** by:

- negotiating the most advantageous price and terms for payment of the purchase price that are possible for the acquisition of income-producing property;
- fully analyzing the property and documenting every aspect of a competent due diligence investigation;
- preparing a thorough representation of the advantages and disadvantages of the property that affect its value for investor review; and
- having the prior management experience needed to operate the property as a reasonably well-informed and prudent owner would.

For a syndicator, a broker license lends credibility and stature to their investment program.

A capable syndicator

To successfully engage in the activities of a syndicator, a broker needs to have the proper aptitude and experience. Fundamentally, this includes the ability to select suitable property for the right *price*, on the right *terms*, at the right *time* and in the right *location*. However, more specialized capabilities are needed, such as the ability to:

- enter into purchase agreements;
- conduct a due diligence investigation and analysis of a property;
- arrange purchase-assist financing;
- determine the proper vesting for title;
- manage the landlord-tenant relationship;
- preserve the property's value by repair, maintenance and replacements; and
- account for income, expenses and mortgage payments.

Properly honed, the composite of these abilities represents an **expertise** sufficient to cope with the foreseeable challenges presented by the group ownership of income-producing real estate. The broker possessing these qualities demonstrates they are qualified to manage a real estate investment program either individually or for a group.

Without a background of education, training and experience in each the acquisition, financing, ownership and disposition of income property, a broker is not fully qualified to lead a group of unsophisticated investors into the co-ownership of income-producing real estate.

A local track record of achievements

The **personal achievements** of a syndicator also lend much credence to their syndication efforts.

Investors sense a greater probability of success in an investment selected and managed by an accomplished individual — one they perceive to have power — when their personal credentials include:

- at least three years' experience as a property manager, operating their own income-producing properties or managing properties on behalf of others;
- at least three years' experience as an appraiser or as a broker providing informed opinions of value;
- creditworthiness and lender confidence sufficient to qualify for loans themselves without relying on a co-signer or guarantor;
- cash reserves for emergencies, separate from funds used for investment;
- accumulated wealth, preferably in the form of equities in real estate;
- community service, such as involvement in civic affairs, both social and political;
- longevity of family as residence in the community;
- higher education and studies in real estate and business;
- licensing in related trades, such as real estate, construction, appraisal, and lending;
- personal accomplishments of notable merit; and
- existing income from sources other than up-front fees for the current syndication of property.

Chapter 37 Summary

Through the syndication of income-producing property, the broker will correspondingly build net worth and receive additional flows of income from fees for management services and distributions of spendable income.

For brokers, syndication is a source of mixed income:

- part of their income will come from the wealth in ownership of fractional interests in real estate; and
- part of their income will come from fees for brokerage services rendered.

The broker negotiating the purchase of property and soliciting investors experiences an indirect benefit for having earned a license and the right to conduct business as a broker. They will be viewed by investors as having achieved the necessary credentials to make them capable of managing syndication.

Further, prudent brokers carry professional malpractice insurance, called errors and omissions (E&O) insurance. Coverage for negligent misrepresentations, available to licensed broker syndicators, further places the investors' mind at ease about the integrity of the syndicator and the mitigation of risk.

Chapter 37 Key Terms

Chapter 38

The distribution of income

Learning Objectives

After reading this chapter, you will be able to:

- determine each member's ownership share in the limited liability company (LLC) as the percentage their capital contribution represents of the total amount of all forms of member contributions; and
- manage the disbursement of spendable income from property operations and net proceeds from a refinance or sale between Class A cash investors and any Class B members, such as the syndicator.

Key Terms

cash-on-cash return

reserve account

parity distribution

Contributions set share of ownership

Consider a limited liability company (LLC) that is initially capitalized at $500,000 consisting of:

- $400,000 in cash contributed by a group of investors; and
- $100,000 in the value of the syndicator's contribution by assignment of their right to purchase the property acquired by the LLC.

The cash investors receive **Class A priority membership interests** in the LLC set at $400,000. In contrast, the syndicator receives a **Class B subordinated membership interest** in the LLC set at $100,000 for the purchase rights to real estate they assigned to the LLC.

Each member's share of ownership in the LLC is set as the percentage each member's contribution represents of the total of all contributions to the LLC.

Thus, the Class A members collectively hold an 80% participation in ownership. The syndicator as a Class B member holds a 20% participation in ownership.

Allocation of cash contributions

Continuing our previous example, the vesting of ownership to the property purchased will be in the name of the LLC, not the members or the syndicator. The members own the LLC, not the real estate. However, the stated purpose of the LLC may be to hold title in trust for the members who as *tenants-in-common* are the actual co-owners of the real estate.

From the $400,000 in cash contributions, $340,000 is used as a **down payment** to fund the acquisition of the property — funds the LLC needs in order to close the purchase escrow and acquire title.

reserve account
An account established by a limited liability company (LLC) to cover miscellaneous transactional costs incurred to create the LLC and purchase the property, and for unexpected operating expenses. [See **RPI** Form 371 §13]

$30,000 from the cash contributions is placed in a **reserve account** the LLC maintains.

From the *reserve account*, the LLC pays:

- miscellaneous closing costs;
- attorney fees;
- accounting fees;
- printing costs; and
- other out-of-pocket **transactional expenses** incurred to create the LLC and purchase the property.

The balance remaining unused in the reserve account serves as a **contingency fund** for unexpected *operating expenses* that typically confront all new owners of property.

The remaining $30,000 is paid to the syndicator as a fee to compensate them for their time and effort spent soliciting investors and organizing the LLC. The $30,000 cash fee paid to the syndicator is for services rendered. This compensation is separate from the 20% subordinated Class B membership interest the syndicator received in exchange for the assignment of their right to purchase the property.

The syndicator's contribution and share

Typically, a syndicator is not also a cash investor though they may be.

The dollar amount given the *Class B membership share* the syndicator receives in the LLC is set by the syndicator. The amount set is based on the dollar value the syndicator places on the contract right they hold to purchase the property. In exchange for the assignment of the purchase rights to the LLC, the syndicator receives the set dollar amount of Class B subordinated interest in the LLC. This dollar sum is a prerequisite to establishing their percentage share of membership.

The cash investors — one of whom could be the syndicator if they also chose to contribute cash — hold *Class A* memberships. As cash contributors, Class A investors receive a *priority distribution* of earnings under the LLC operating agreement, including:

- **spendable income** from property operations; and
- **net proceeds** from the refinance or resale of the property. [See **RPI** Form 372]

For example, the operating agreement entitles the Class A members to first receive a distribution of annual spendable income generated by the property. Only then may the syndicator (and any other Class B members) receive spendable income. This priority distribution to Class A members is limited in amount to an annual percentage on their cash contribution, a **cash-on-cash return** comprising a return of capital (due to depreciation deductions) and ordinary income.

cash-on-cash return
Spendable income stated as a percentage of total member contributions to equity capital, represented by operating income remaining after all expenses and mortgage payments have been paid and before depreciation deductions or income taxes.

The spendable income the syndicator receives as their Class B *subordinated distribution* is the same annual percentage return on the dollar amount of their contribution as the Class A investors receive on theirs.

Any spendable income remaining after minimum distributions is next distributed among all the members on a pro rata basis, based on the percentage share they hold in the LLC. This distribution is without concern for priorities or subordination, called a **parity distribution**.

parity distribution
An equal sharing between all members in a limited liability company (LLC) of earnings in the form of spendable income and proceeds of a sale or refinance.

However, a different ratio of sharing between classes is occasionally established by the syndicator for these *parity distributions*. For example, the spendable income remaining after priority distributions might be distributed 50% to Class A members and 50% to Class B members.

When the syndicator's percentage share of excess spendable income is larger than their pro rata ownership, the syndicator has greater incentive to increase the spendable income generated by the operations of the property. This self interest in maximizing spendable income in turn increases the property's value due to management increasing rental income or reducing operating costs, or both.

Over time, and due to inflationary increases in rents and thus spendable income, these alternative percentages for sharing can shift great future wealth to the syndicator.

Distribution on a refinance or sale

Distribution of the net proceeds from a **refinance** or **sale** of the LLC property follows a similar priority format for sharing.

The Class A members receive the first distribution of proceeds from a refinance and sale up to the dollar amount of their original contributions, plus any unpaid minimum annual distributions.

Any portion of the annual minimum rate of return not available for distribution during prior periods of ownership accumulates and is distributed as funds from any source as they become available.

Next, the Class B syndicator receives a distribution from the refinance and resale proceeds up to the dollar amount of their capital contribution. Added to this is any annual minimum rate of return not previously available for distribution that has accumulated unpaid.

Any refinance or sales proceeds then remaining are typically distributed on a parity basis to all members. For example, the agreement may call for the remaining funds to be distributed to all members based on their percentage of membership, or on a different ratio, such as a 50-50 split between the Class A and Class B members, or any other ratio agreed to.

Finally, the manager, as a licensed real estate broker, may receive a fee for their management, refinance, and sale of the property.

The right to a fee for services rendered to the LLC is contracted for in the operating agreement. As payment for services, the distribution of brokerage fees has priority over distributions to capital investors. [See **RPI** Form 372]

Chapter 38 Summary

Cash investors in a limited liability company (LLC) receive Class A membership interests. Thus, Class A investors receive a priority distribution of earnings under the LLC operating agreement, including:

- spendable income from property operations; and
- net proceeds from the refinance or resale of the property

This priority distribution to Class A members is limited in amount to an annual percentage on their cash contribution, a cash-on-cash return comprising a return of capital (due to depreciation deductions) and ordinary income.

In contrast, the syndicator receives a Class B subordinated membership interest in the LLC. The dollar amount of the membership share the syndicator receives in the LLC is based on the dollar value the syndicator places on the contract right to purchase the property they assign to the LLC. The spendable income the syndicator receives as their subordinated distribution is the same annual percentage return on the dollar amount of their contribution as the Class A investors have received on theirs.

Any spendable income remaining after minimum distributions is next distributed among all the members on a pro rata basis, based on the percentage share they hold in the LLC. This distribution is without concern for priorities or subordination, called a parity distribution. However, a different ratio of sharing between classes is occasionally

established by the syndicator for these parity distributions. For example, the spendable income remaining after priority distributions might be distributed 50% to Class A members and 50% to Class B members. Here, the syndicator has greater incentive to increase the spendable income generated by the operations of the property.

Distribution of the net proceeds from a refinance or sale of the LLC property follows a similar priority format for sharing.

Chapter 38 Key Terms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PROFESSOR BILL
SELLER'S AGENT
BUYER'S AGENT
VIDEO RENEWAL COURSE™
LOVE MOVIES?
LOVE MOVIES?
Knock out your CE with the only cinematic license renewal in California
Enroll now

Chapter 39

Sharing earnings through services and capital contributions

Learning Objectives

After reading this chapter, you will be able to:

- identify your compensable activities as a syndicator;
- analyze the numerous arrangements for sharing income and profits with the co-owners in a group investment program;
- share in the net proceeds on a resale of co-owned property as a subordinated co-owner to avoid the moral hazard of a parity basis participation; and
- appreciate the various services you can provide for compensation as a syndicator.

Key Terms

conflict of interest	**moral hazard**
equity financing	**net operating income (NOI)**

The tradeoff in priority distributions of income

An income-producing property generates an annual **net operating income (NOI) or loss** during any given period of time. Whether income or loss is created depends on how well managed the property is.

net operating income (NOI)
The net revenue generated by an income producing property, calculated as the sum of a property's gross operating income less the property's operating expenses and used to determine a property's value and pay mortgage debt. [See **RPI** Form 352 §4]

During the duration of ownership, the property will experience an annual rise or fall in the dollar amount of its fair market value (FMV). Value fluctuations are triggered by a multitude of factors, including some with no correlation to the management of the property, including:

- national consumer price inflation;
- monetary policy of the Federal Reserve (the Fed);
- construction starts;
- local politics of zoning, code enforcement and infrastructure; and
- increased or decreased local demographics of population density and wages.

The zero-sum game of sharing

For the owners of a property, the *NOI* it produces and any net rise in its value constitutes the sum of the earnings generated by the property during the period of ownership (less mortgage interest paid).

When an income property is co-owned by investors and a syndicator, vested in the name of a limited liability company (LLC), the earnings produced by rental income and rising property value are shared. Any increase in one co-owner's share of the earnings, such as the syndicator's share, produces an *equal decrease* in the earnings remaining available to the other co-owners, i.e., the investors.

This is a perfect mathematical illustration of a **zero-sum game**.

In the environment of a syndicated investment, that portion of the property's earnings (NOI and net resale value) taken first by the syndicator reduces the amount of rental income and property value available for disbursement to cash investors.

Alternatively, a *priority allocation* to cash investors on distribution of spendable income and net proceeds from refinancing and resale of the property draws down the earnings available for distribution to the syndicator. Thus, under one formula or another, all co-owners share in an absolute and finite sum of dollars represented by the NOI remaining after interest expenses and any build-up (mortgage principal reduction) or rise in the property's equity value.

Share and share alike, when alike

Consider a syndicator who negotiates a $300,000 down payment for the purchase of a property. The down payment is funded by contributions of $50,000 from each of six investors who join with the syndicator to co-own the property. The syndicator receives an equal additional share (1.7^{th}) in ownership for locating the property and contracting to purchase it. The total capital contribution from all members in all forms is $350,000.

Any percentage of the income and profits the syndicator is to receive for their share of ownership reduces the earnings available to the cash investors who funded the down payment made to acquire the property.

Here, the cash investors put up 100% of the cash funds needed to buy the property, but receive only 6/7 (86%) of the ownership. The syndicator's $50,000 co-ownership valuation represents 1/7 (14%) of the total $350,000 capitalization of the investment group. Thus, the purchasing power of the investor's cash has been diluted by the percentage of ownership received by the syndicator, referred to as **watered stock**.

The property is acquired by the group at its current FMV. Further, the syndicator receives no part of the down payment from the seller or anyone else. Here, the syndicator receives no compensation or benefits for their acquisition and group formation efforts, other than the 14% of co-ownership they were able to justify as the value of their right to purchase the property which was assigned to the limited liability company (LLC) which acquires the property.

As a result, the syndicator (as well as each investor) will receive 14% of any distributions of net income, refinancing and sales proceeds.

The moral hazard in parity sharing

Continuing our previous example, consider a resale of the same income property by the group.

The price received reflects an increase in value equal only to the transactional costs incurred to sell the property. Thus, the net proceeds from the resale are $300,000, the same amount as the original down payment.

On distribution of the net sales proceeds to the investment group composed of the syndicator and the six investors, the syndicator receives $42,857, 14% of the $300,000 net proceeds. The investors will receive the 86% remainder of the proceeds, $257,143. Thus, each of the investors who funded the entire down payment will receive $42,857 as the return of their $50,000 investment, resulting in a cash loss on the sale exceeding $7,000 each, the result of the *share and share alike formula*.

Since the investors acquired **parity ownership** with the syndicator, the syndicator shares with the investors each dollar of net proceeds from the resale. This sharing creates the inherent **risk of loss** known as a **moral hazard.** The risk to the investors is that the syndicator will receive cash on any sale without concern for the quality of the property selected, day-to-day operations, care for the property or the effective marketing of the property to obtain the highest resale price.

moral hazard
An investment situation in which the risk of loss is borne primarily by a group of investors, not the syndicator, structured to discourage the syndicator from working for results that exceed minimum performance standards and motivate the syndicator to take unacceptable risks.

The compensation a syndicator receives when they share net sales proceeds on a *parity basis* with the investors is not contingent on the syndicator's performance. The syndicator's compensation is also not subject to a priority return of the investors' cash contributions, the returns to the syndicator being junior and subordinated to the investors'. The risk of loss situation created by parity participation allows the syndicator to merely sit and wait for a sale in order to benefit financially from their initial syndication efforts.

The likelihood of a return of contributions

Investors need to be given a reasonable likelihood their invested capital will be returned together with the income and profits they have been led to anticipate on their investment.

To attain these objectives, the investment program needs to include a mix of:

- cash distributions during co-ownership based on a formula mix of priorities, subordination and parity participation between all co-owners;
- front-end reimbursement of the syndicator's out-of-pocket expenditures for acquisition (transactional) costs, LLC organizational expenses and purchase agreement deposits;
- co-ownership participation by the syndicator in lieu of a cash payment equal to the value of the assignment to the LLC of their right to purchase the property;

Sidebar

Conflicts in a real estate syndication

conflict of interest
When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **RPI** Form 527]

*A **conflict of interest** arises when a broker or their agent, acting on behalf of a client, has a competing professional or personal bias which hinders their ability to fulfill the fiduciary duties they have undertaken on behalf of their client.*

In the context of syndication, a conflict of interest exists when a syndicator has a professional or personal bias toward others which interferes with their ability to arrange the acquisition and management of an income-producing investment property on the most advantageous terms for a group of investors.

*A potential conflict of interest exists when a broker **manages multiple LLCs** which own like-type properties in the same market area.*

For example, consider a syndicator entrusted with managing two investment groups which own similar apartment projects located within the same market. The two projects thus compete for the same prospective tenants. The syndicator is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the syndicator is initially faced with the dilemma of which apartment building to refer the tenant to, and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions by multiple LLCs managed by the same syndicator that are actively competing to sell or buy property within the same marketplace.

A potential conflict of interest of this nature needs to be disclosed to the investors before they agree to participate as members in an LLC the syndicator manages.

*This disclosure is contained in **RPI** Form 371, Investment Circular provision 6d, which states:*

> ***Conflicts of Interes**t: The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **RPI** Form 371]*

*With this disclosure, the **syndicator's allegiance** to multiple projects and investment groups is transparent and is be taken into consideration by all investors at the time they receive the Investment Circular from the syndicator – before investing and consenting to the risk.*

- fees for services performed by the syndicator to form the LLC, prepare an investment circular (IC), locate investors and for property management duties during ownership of the property;
- minimum annual earnings on contributions, cumulative if not disbursed;
- separate classes of ownership for the different tiers of sharing arrangements, called **tranches**; and
- fees earned by the syndicator based on graduated percentages for achieving higher levels of income and profit.

Investors are less likely to invest in programs that include:

- parity participation between the investors and the syndicator in distributions; and
- up-front fees to the syndicator which exceed the reimbursement of their out-of-pocket costs for LLC organization and transactional costs of property acquisition.

As a requisite to structuring the sharing of earnings and wealth flowing from a property, the syndicator places a dollar value on their participation in co-ownership.

Once the dollar value of the syndicator's co-ownership is set, the *percentage* of the dollar amount of each co-owner's contributions to the total of all contributions made establishes the basis for pro rata participation in income, profits and the return of capital.

Preliminarily, the dollar amount the syndicator sets for their co-ownership interest is to be based on the value of the purchase agreement rights they negotiated and contributed by assignment to the LLC. The dollar amount set for assigning the purchase rights is justified as:

- reasonable; and
- based on objective standards of evaluation.

The phases of a syndicated investment

There are three compensation phases to the *syndicator's participation* during the ownership of a syndicated investment program:

- the **pre-acquisition period**;
- the **ownership period**; and
- the **disposal period**.

Phase 1. The pre-acquisition period

1.1 **Search** for and locate suitable property.

1.2 **Select** a property that appears suitable to acquire based on unconfirmed seller disclosures.

1.3 Enter into a **Letter of Intent** or an agreement to purchase the property (likely at a net price reduced by the amount of a brokerage fee, say 6%). [See RPI Form 185]

1.4 Complete a **due diligence investigation** into the property and either terminate negotiations and cancel the agreement, or proceed to perform on the purchase agreement. [See **RPI** Form 159]

1.5 Dictate and execute **escrow instructions** to process the closing of the purchase agreement. [See **RPI** Form 401]

1.6 Deposit **good faith money** in escrow and arrange mortgage financing if it is required.

1.7 Prepare an **Investment Circular (IC)**. [See **RPI** Form 371]

1.8 Prepare the LLC **operating agreement**, setting the ratios and formulas for investor and syndicator participation in earnings. [See **RPI** Form 372]

1.9 Solicit **commitments** from investors to subscribe to the LLC and contribute cash.

1.10 **Record** the LLC articles when the investment is fully subscribed.

1.11 **Assign** the syndicator's right to purchase the property to the LLC. [See **RPI** Form 370]

Phase 2. The ownership period

2.1 The syndicator receives a share of ownership in the LLC in exchange for an **assignment of their purchase rights** to the LLC. In turn, the investors receive a share for their **cash contributions**.

2.2 **Manage** the property.

2.3 Experience **equity buildup** due to the amortization of the loan amount through monthly payments.

2.4 Distribute **spendable income** generated from the operations of the property to the co-owners.

2.5 **Refinance** the existing loan and distribute any **net loan proceeds** and any resulting increase in spendable income to the co-owners.

2.6 **Buy out** the investors on a **right of first refusal** or **purchase option** held by the syndicator.

Phase 3. The disposition period

3.1 Facilitate a vote of the co-owners authorizing the **sale** of the property, when the time is right to sell.

3.2 Employ the syndicator as the seller's broker to **list** the property for sale and **locate** a buyer.

3.3 Prepare a **marketing package** for delivery of disclosures and representations about the property to prospective buyers. [See the **RPI** Income Property Brokerage suite of forms]

3.4 Enter into a **purchase agreement** to sell the property to a buyer and open escrow. [See **RPI** Form 159]

3.5 Cooperate and assist the buyer in their **due diligence investigation** of the property and close the sale.

3.6 **Disburse brokerage fees** to the syndicator from the net sales proceeds.

3.7 Distribute the remaining net sales proceeds to the **co-owners**.

3.8 Record the **dissolution of the LLC**.

The syndicator's earnings

Throughout this chronology of events, your analysis needs to focus on the economic (and taxable) nature of the syndicator's activities as either:

- **capital events**; or
- **services rendered**.

This economic analysis arises when the syndicator accepts a co-ownership interest, sets priorities, parities or accumulation of earnings and collects fees to be disbursed out of the property's rental income and rise in value. The distinctions have financial and tax consequences for the syndicator.

To begin an analysis of the aspects of sharing, the syndicator's activities which generate earnings during each phase of real estate syndication are broken down and categorized based on their nature as:

- *capital contributions* to the LLC; or
- *services rendered* on behalf of the LLC.

Each are taxed differently; the income from capital contributions at *passive income* category rates, the services rendered at *trade or business* category rates.

Differentiated activities

The syndicator's activities are differentiated as follows:

1. **Acting as a principal — the syndicator's capital ownership activities :**

 1.1 *Acquisition phase:*

 a. Enter into a **purchase agreement** in their own name as the syndicator. [See **RPI** Form 159]

 b. **Open escrow** to purchase the property in their own name.

 c. Fund the **good faith deposit** into escrow.

 d. **Transfer** the rights to purchase the property by an assignment to the LLC. [See **RPI** Form 370]

 1.2 *Ownership phase:*

 a. **Participate as a member** who co-owns a share in the LLC.

 b. Participate in the **equity buildup** in the property by the monthly amortized reduction in debt.

 c. Share **spendable income** generated from the operations of the property when it is distributed to co-owners.

 d. Share the **net proceeds** from a refinance on their distribution to co-owners.

 e. Exercise the **right of first refusal** or **option to buy the property** or fractional ownership interests granted to the syndicator by the investors.

 1.3 *Marketing and resale phase:*

 a. Vote as a co-owner to **sell** the property.

 b. Enter into a **purchase agreement** and escrow to sell the property.

 c. Share the **net sales proceeds** on their distribution to co-owners.

 d. Complete the **dissolution of the LLC**.

2. **Acting as a broker — the syndicator's services representing the LLC:**
   2.1 *Acquisition phase:*
   a. Prepare an IC to mar**ket LLC shares**. [See **RPI** Form 371]
   b. Arrange to assume or originate **mortgage financing**.
   c. **Solicit investors** to contribute capital and enter into an LLC operating agreement. [See **RPI** Form 372]
   d. **Form the LLC** by preparing, signing and recording the LLC-1 Articles of Organization.

   2.2 *Ownership phase:*
   a. **Manage the property** under a property management agreement with the LLC. [See **RPI** Form 590]
   b. Arrange any **refinancing or further encumbrance** of the property.
   c. Locate **substitute co-owners** on resale of an existing co-owner's fractional interest.

   2.3 *Marketing and resale phase:*
   a. Market the property for sale and **locate a buyer** under a listing agreement.
   b. **Prepare a marketing package** to deliver property disclosures to prospective buyers. [See the **RPI** Income Property Brokerage suite of forms]
   c. Cooperate and assist the buyer in their **due diligence investigation** of the property and close the sale.

Rationale for sharing profits

As discussed above, when a syndicator proceeds with the acquisition of an investment property on the completion of their due diligence investigation, the IC is prepared. The IC is used for marketing fractional ownership interests when soliciting contributions from cash investors. [See **RPI** Form 371]

The IC includes an LLC operating agreement that authorizes the employment of the syndicator, for a fee, to manage the day-to-day operations and management of the property, including handling refinancing and resale of the property. It further authorizes the syndicator to distribute the earnings, profits and capital from these activities to the co-owners of the LLC. [See **RPI** Form 372]

However, before preparing the operating agreement, the syndicator determines the nature of their participation in the income and the extent of sharing in the earnings generated by the property and their management.

To spur interest in the investment opportunity among prospective investors, the syndicator needs to demonstrate that the formulas for sharing the earnings will, as a matter of priority distributions, deliver to the investors:

- a return of their invested capital;

- minimum annual spendable income as a priority; and
- an acceptable portion of any increase in value on a refinance or resale of the property.

Collectively, the property's physical condition and co-owner income-sharing formulas need to be sufficiently attractive and fully transparent to induce prospective investors to commit their funds to capitalize the investment, called **equity financing**.

equity financing
Down payment funds solicited from cash investors by a syndicator for the purchase of an income-producing investment property to be co-owned by a group of investors. Contrast with mortgage financing.

Avoiding a moral hazard

For the risk of loss in an investment to be acceptable to prospective investors, the syndicator needs to use substantially all the cash contributions to fund the down payment for the purchase of the property.

To avoid creating *moral hazards* for investors arising out of the syndicator's decisions, the syndicator's fees and earnings need to be structured to encourage the syndicator to work for results that exceed **minimum performance standards**. To accomplish this, the syndicator's ownership interest is subordinated to priority disbursements to the investors from spendable income and net proceeds from a refinance or sale of the property.

Similarly, the syndicator needs to disclose the fee they will be paid for their **organizational services** to form the LLC, solicit investors and bring together the co-owners. Thus, the fees need to be competitive with the fees charged by others who provide similar services, such as attorneys.

Further, the **property management fee** the syndicator has bargained for needs to be shown as fair for the quality, quantity and reliability of their services. To do so, the fee needs to be consistent with the charges for like services provided by competitive property managers actively operating in the area. [See **RPI** Form 590]

To avoid a moral hazard, it is the syndicator who will initially absorb the investment's risk of loss from any decline in rental income (increased costs) or property value, not the investors. This investor benefit flows from the provisions for *priority distributions* to the investors.

Floors and ceilings on returns

Earnings and thus distributions are shared between the syndicator and the investors under various formulas.

Sharing arrangements take into consideration:

- priority and parity sharing;
- ratios for sharing;
- a minimum annual return that accumulates if unpaid;
- contingency fee arrangements;
- the dollar value of the syndicator's contribution; and
- buy out options.

Collectively, these arrangements **place a ceiling** on the total return the cash investors are able to receive over the life of the investment. Thus, from the syndicator's point of view, the cash raised from investors is called **equity financing**, the other type of funds being called **mortgage financing**.

Arrangements for sharing

The following outline analyzes the various arrangements for sharing:

1. **Structuring an LLC's capitalization and sharing by co-owners:**

   1.1 *The investors' contribution of cash provides for:*

   a. A **percentage of ownership** in the LLC as **Class A members**.

   b. A **periodic distribution** of spendable income between Class A and Class B members.

      1) Initial priority distribution to Class A members.

      2) Initial distribution as a minimum rate of return.

   c. A **supplemental distribution** of remaining **spendable income**.

      1) Parity distribution to members of all classes of any spendable income remaining after initial distributions to Class A and B members at the minimum rate of return.

      2) Parity sharing by all LLC members is based on percentage of ownership or another agreed ratio, such as 50:50 between classes.

      3) Distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

      4) Spendable income remaining after distributions to Class A members at the maximum annual rate is distributed to Class B members.

   d. An initial distribution of the **net proceeds** from a refinance or sale of the property.

      1) Priority distribution to Class A members.

      2) Initial priority distribution to Class A members limited to the dollar amount of their contributions and a minimum annual rate of return, less all distributions they have previously received.

   e. **Supplemental distribution of net proceeds** remaining from the refinance or sale of the property after initial priority distributions.

      1) Parity sharing between classes is based on percentage of ownership or another agreed ratio, such as 50:50.

      2) Distribution of the remaining net proceeds to Class A members may be capped at a maximum annual rate of return on their original capital contributions, such as a rate equal to the consumer price index (CPI) for the term of the investment and an annual percentage rate, such as 4% or 6%.

Arrangements for sharing, cont'd

1.2 *The syndicator's contribution of purchase rights provides for:*

a. A dollar amount of ownership in the LLC as a **Class B member**.

   1) The dollar value the syndicator places on their Class B membership received for their contract right to purchase the property establishes in relationship to all contributed capital the syndicator's percentage of ownership in the LLC.

b. A **periodic distribution** of spendable income to Class B members.

   1) Distribution is subordinated to the annual floor rate of return initially distributed to Class A members.

   2) The distribution is initially limited to an annual floor rate of return identical to the rate of return for priority distribution of spendable income to Class A members.

c. A **supplemental distribution** of remaining **spendable income**.

   1) Parity sharing of spendable income between all member classes.

   2) The ratio for parity sharing is based on percentage of ownership or another agreed ratio, such as 50:50.

   3) The parity distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

d. A distribution of all **remaining spendable income**.

   1) After initial and parity distributions to Class A and B members, any remaining undistributed spendable income is distributed solely to Class B members.

e. A **subordinated distribution** of proceeds from a refinance or a sale of the property.

   1) Distribution to Class B members is subordinated to the initial priority distribution to Class A members.

   2) Distribution to Class B members is limited to the dollar amount of their contributions and an annual minimum rate of return identical to the rate of return for priority distributions of proceeds to Class A members, less all distributions Class B members have previously received.

f. **Supplemental distribution of net proceeds** remaining from the refinance or sale of the property.

   1) Parity distribution of proceeds between classes may be based on percentage of ownership or another agreed ratio, such as 50:50.

Arrangements for sharing, cont'd

2) The amount of the parity distribution of proceeds to Class A members may be capped at an annual ceiling rate of return on their original capital contributions, such as a rate equal to the CPI for the term of the investment and an annual rate of return, such as 4% or 6%.

g. A distribution solely to Class B members of net proceeds remaining undistributed after priority and parity distributions to Class A and Class B members.

1.3 *Buy out provisions represent:*

a. A **right of first refusal** granted to the syndicator in the operating agreement to acquire, at a formulated price, a co-owner's fractional interest on the co-owner's withdrawal, death, expulsion by court order or by all remaining members, etc.

b. An **option** granted to the syndicator in the operating agreement to acquire the interests of the Class A members at a formulated price, comparable to a preferred stock arrangement by which a corporation pays off the stockholder. Alternatively, an option may be granted to the syndicator to buy the property from the LLC.

2. **Fees and benefits for services rendered to the LLC by the syndicator:**

2.1 Acquisition fee or listing fee:

a. Paid directly to the syndicator by the LLC out of cash contributions for **brokerage services** rendered by the syndicator to negotiate the purchase, or less prudently, paid indirectly to the syndicator by the seller of the property out of the down payment.

b. Received by the syndicator **in lieu of a percentage of ownership**.

2.2 Organizational or formation fee:

a. Received by the syndicator from the LLC for services the syndicator rendered to **prepare** an IC, **solicit** cash investors and **form** the LLC entity.

b. Paid on the LLC's **acquisition of ownership** from cash contributions.

2.3 Property management fees:

a. Paid to the syndicator as a licensed broker at the end of each month in an amount based on a **percentage of the rents collected**.

b. Received by the syndicator as a licensed broker rendering services under a **property management agreement**. [See **RPI** Form 590]

Arrangements for sharing, cont'd

c. Payment of the management fee may be **contingent on the sufficiency of rents** to cover operating expenses and mortgage payments.

d. Payment of the fee may be **further subordinated** to the distribution of a minimum annual rate of return to the Class A members and, if the fee is unpaid, will accumulate and be payable in later years when spendable income is available.

2.4 Loan brokerage fee:

a. Received by the syndicator as a licensed broker for arranging the **refinancing or further financing** of the property.

2.5 Miscellaneous income and financial benefits:

a. Income received by the syndicator as reimbursement for expenses incurred in the **management of the LLC and the investors**, other than the management of the property.

b. Income received by the syndicator for providing services which are **not obligations of the LLC** under the leases. These services are paid for by tenants separate from the rent through common area maintenance fees (CAMs), a tenant association, laundry equipment and supplies or vending machines.

c. Profits from a **maintenance company** controlled by the syndicator that provides services for the care and maintenance of the LLC property. [See **RPI** Form 519]

d. **Rent-free** or **rent-reduced occupancy** of vacant space by the syndicator for their personal or business use, whether or not it is coupled with the management of the property.

2.6 *Sales fees or listing fees*

a. Received by the syndicator as a real estate broker from the net proceeds on a sale of the property, paid by the LLC.

3. **A master lease held by the syndicator on the property acquired by the LLC:**

3.1 Rent paid to the LLC:

a. Rent under the **master lease** is the sole source of a periodic return on the co-owners' invested capital.

3.2 Right to buy:

a. Rights of **first refusal, buy-out options** and **options to purchase** the property at a gain for the investors (in addition to rent) are granted to the syndicator to buy the property or buy out the cash investors.

Chapter 39 Summary

An income-producing property generates an annual net operating income (NOI) or loss during any given period of time. For the owners of a property, the NOI it produces and any net rise in its value constitutes the sum of the earnings generated by the property during the period of ownership (less mortgage interest paid).

When an income property is co-owned by investors and a syndicator, vested in the name of a limited liability company (LLC), the earnings produced by rental income and rising property value are shared. Any increase in one co-owner's share of the earnings, such as the syndicator's share, produces an equal decrease in the earnings remaining available to the other co-owners, i.e., the investors.

To attain these objectives, the investment program needs to include a mix of:

- cash distributions during co-ownership based on a formula mix of priorities, subordination and parity participation between all co-owners;
- front-end reimbursement of the syndicator's out-of-pocket expenditures for acquisition (transactional) costs, LLC organizational expenses and purchase agreement deposits;
- co-ownership participation by the syndicator in lieu of a cash payment equal to the value of the assignment to the LLC of their right to purchase the property;
- fees for services performed by the syndicator to form the LLC, prepare an investment circular (IC), locate investors and for property management duties during ownership of the property;
- minimum annual earnings on contributions, cumulative if not disbursed;
- separate classes of ownership for the different tiers of sharing arrangements, called tranches; and
- fees earned by the syndicator based on graduated percentages for achieving higher levels of income and profit.

A syndicator who shares equally in the net sales proceeds is on a parity basis with the investors. Parity allows the syndicator to share and share alike with the investors all the net cash on the resale, creating a risk of loss known as a moral hazard. Here, the syndicator receives cash on any sale without concern for the quality of the property selected, the day-to-day operations, care of the property or the effective marketing of the property to obtain the highest resale price.

To avoid creating moral hazards for investors arising out of the syndicator's decisions, the syndicator's fees and earnings need to be structured to encourage the syndicator to work for results that exceed minimum performance standards. To accomplish this, the syndicator's ownership interest is subordinated to priority disbursements to the investors from spendable income and net proceeds from a refinance or sale of the property.

Further, the syndicator needs to show the fees they will be paid for their organizational and management services are:

- reasonable;
- based on objective standards of evaluation; and
- competitive with the fees charged by others who provide similar services.

Chapter 39 Key Terms

Glossary

A

ad valorem taxes 221
Real estate taxes imposed on property based on its assessed value. [See **RPI** Form 552-2 §5.1]

addendum 340
An attachment to a rental or lease agreement for incorporating any provision agreed to but not included in the boilerplate provisions of the agreement. [See **RPI** Form 250]

adjusted gross income (AGI) 356
The total of the taxpayer's reportable income and losses from all three income categories.

agency duty 156
The fiduciary duty a broker owes a client to use diligence in attaining the client's real estate goals. [See **RPI** Form 305]

anchor tenant 40
A large, well-branded retailer strategically situated in a multi-unit shopping complex to draw foot-traffic and consumers for the general benefit of all tenant occupants in the complex.

Annual Property Operating Data sheet (APOD) 49, 327
A worksheet used when gathering income and expenses on the operation of an income producing property, to analyze its suitability for investment. [See **RPI** Form 352]

appreciation adjusted rent provision 239, 244
A rent provision found in a commercial lease agreement which adjusts rent every several years to reflect an increase in the rental value of a property exceeding the rate of inflation brought about by local demographics. [See **RPI** Form 552 §4.5e]

appurtenance 262
A right belonging to real estate owned by the landlord to use property located outside the leased premises for purposes such as parking or access.

asset price inflation 1
A rise in the price of assets, such as stocks, bonds and real estate.

assumption 297
The promise by a successor tenant to fully perform all obligations under the lease agreement they are taking over by assignment from the previous tenant.

attorney fees provision 218
A provision in an agreement permitting the prevailing party to a dispute to receive attorney fees when litigation arises due to the agreement. [See **RPI** Form 552 §23.2]

attornment clause 317
A lease agreement provision which allows an owner by-foreclosure to unilaterally avoid the automatic elimination of a junior leasehold interest by a foreclosure sale and become a substitute landlord under the tenant's lease agreement. [See **RPI** Form 552-8 §3]

B

balance sheet 180
An itemized, dollarvalue presentation for setting an individual's net worth by subtracting debt obligations (liabilities) from asset values. [See **RPI** Form 209-3]

base rent 225, 236, 253
The minimum monthly rent due under a commercial lease agreement. [See **RPI** Form 552 §4.3]

bona fide purchaser 209
A buyer of leased real estate who lacks knowledge that a lease agreement exists and purchases the property for valuable consideration or accepts the real estate as security for a debt.

book value........348
The current value for accounting purposes of an asset expressed as original cost plus capital additions minus accumulated depreciation.

C

call option........287
An agreement giving a buyer the right to buy property within a specified time or upon an event at a specified price with terms for payment. [See **RPI** Form 161]

capitalization (cap) rate........24, 34, 75
The annual rate of return on invested capital produced by the operations of an income property. The cap rate is calculated by dividing the net operating income by the property's price.

cash-on-cash return........375
Spendable income stated as a percentage of total member contributions to equity capital, represented by operating income remaining after all expenses and mortgage payments have been paid and before depreciation deductions or income taxes.

choice-of-law provision........219
A provision specifying California law applies if a dispute arises with a tenant regarding the lease. [See **RPI** Form 552 §23.4]

commingling........129
The mixing of personal funds with client or other third-party funds required to be held in trust.

commodity........1
A marketable good or service.

common area maintenance charge........167
Property operating expenses incurred by a commercial landlord and paid by the tenant as rent in additonal to the base rent, adjustments and percentages. [See **RPI** Form 552 §6]

common interest developments........139
Condominiums projects, cooperatives or single family residences in a planned unit development. [See **RPI** Form 135]

comparative cost analysis........164
A comparison of the costs a tenant will incur to occupy and operate in a particular space against the costs to operate in other available space. [See **RPI** Form 562]

compliance-with laws clause........263
A provision in a commercial lease agreement controlling the conduct of tenant activities on the property to conform with public laws, building ordinances or tenant association rules. [See **RPI** Form 552 §7.3]

conflict of interest........382
When a broker or agent has a positive or negative bias toward a party in a transaction which is incompatible with the duties owed to their client. [See **RPI** Form 527]

constructive notice........210
To be charged with the knowledge observable or recorded conditions exist on the property. When a tenant occupies a property under a lease agreement, a buyer is charged with constructive notice of the tenant's leasehold interest by the occupancy.

consultation fee........156
A fee the broker charges for the time spent locating rental property if the tenant decides not to lease space during the exclusive authorization period. [See **RPI** Form 111 §4.2]

Consumer Price Index (CPI)........244
The CPI measures and tracks the rate of consumer inflation. This is presented as an index of fluctuations in the general price of a wide selection of consumable products – goods and services.

consumer confidence........41
An economic indicator measuring the current level of optimism consumers feel about their personal financial situation and the present state of the broader economy.

contingency fee clause........148
A provision in an offer-to-lease which states the broker's fee is payable on the transfer of possession to the tenant. [See **RPI** Form 556 §15]

corporate resolution **220**
A document from a corporation's board of directors which gives the officers of a corporation the authority to sign and bind the corporation to a lease.

credit application **338**
A document prepared by a prospective tenant which includes a provision authorizing the landlord to investigate and receive information on the tenant's creditworthiness. [See **RPI** Form 302]

D

destruction provision **270**
A provision in a lease agreement in which a tenant agrees to pay for any destruction to the premises caused by the tenant, covered by the tenant's insurance or required by other lease provisions. [See **RPI** Form 552 §16]

dual agency **158**
The agency relationship that results when a broker represents both the buyer and the seller in a real estate transaction. [See **RPI** Form 117]

E

early termination clause **146**
A provision which assures payment of the broker's fee if the owner withdraws the property from the market during the listing period. [See **RPI** Form 110 §3.1c]

eminent domain **218**
The right of the government to take private property for public use on payment to the owner of the property's fair market value.

entire agreement clause **219**
A clause in a lease agreement which limits the tenant's ability to imply terms into the lease based on oral statements made before entering into the lease. [See **RPI** Form 552 §23.5]

equity financing **387**
Down payment funds solicited from cash investors by a syndicator for the purchase of an income producing investment property to be coowned by a group of investors. Contrast with mortgage financing.

errors and omissions (E&O) insurance **368**
An insurance policy protecting brokers and agents from negligent conduct when acting as a licensee.

exclusive authorization to lease **142**
A written agreement between a broker and client employing the broker to render services in exchange for a fee on the leasing the property to a tenant located by anyone. Also known as a listing. [See **RPI** Form 110]

exclusive authorization to locate space **154, 171**
An employment agreement by a broker and a prospective tenant which authorizes the broker to act as the tenant's leasing agent to locate suitable space and negotiate a lease agreement. [See **RPI** Form 111]

exclusive right-to collect clause **146**
A provision which assures payment of the broker's fee if anyone procures a tenant on the terms in the listing, or on terms the landlordowner accepts. [See **RPI** Form 110 §3.1a]

F

final inspection **195**
An inspection of the premises conducted by the landlord within 21 days after a residential tenant vacates the property. [See **RPI** Form 585]

financial accelerator **4**
The cyclical phenomenon of increasingly larger mortgage amounts based on increasingly inflated prices of the same collateral.

fixed-rent lease **225**
A lease agreement with monthly rent payments set at a specific dollar amount for the life of the lease. [See **RPI** Form 552]

full listing offer to lease **145**
A buyer's or tenant's offer to buy or lease on terms substantially identical to the employment terms in the owner's listing agreement with the broker. [See **RPI** Form 556]

full-service gross lease **221**
A commercial lease specifying that the landlord retains the responsibility for payment of all costs of care and maintenance, unless modified, including the tenant's utilities and janitorial services. [See **RPI** Form 552 and 552-1]

further-approval contingency **167**
A provision in an offer to rent property which allows the tenant time to investigate and confirm the property information disclosed by the landlord.

further-improvements provision **102**
A commercial lease provision which allows a landlord to retain tenant improvements or require the restoration of the property to its original condition upon expiration of the lease. [See **RPI** Form 552 §11.3]

future subordination clause **323**
A lease agreement provision in which the tenant agrees to subordinate their leasehold interest in property to a trust deed to be recorded in the future. [See **RPI** Form 552 §17]

G

general duty **156**
The duty a licensee owes to non-client individuals to act honestly and in good faith with upfront disclosures of known conditions which adversely affect a property's value. [See **RPI** Form 305]

going negative **5**
The Federal Reserve's charging of interest of the excess reserves of lenders, stimulating lending activity.

good will **349**
The intangible image or opinion held about a property which affects its earning power.

graduated rent provision **234**
A rent provision in a commercial lease agreement which increases the initial monthly rent in pre-set increments over the term of the lease. [See **RPI** Form 552 §4.4]

gross lease **221**
A commercial lease specifying that the tenant pays for their utilities and janitorial fees, but unless modified is not responsible for any other care, maintenance or carrying costs of the property. [See **RPI** Form 552 and 552-1]

gross operating income (GOI) **25**
The actual income received from all sources that property operations is expected to generate over a 12 month period, from which expenses are paid, mortgage payments made and reserves set aside, any remaining cash being spendable income.

gross revenue multiplier (GRM).......... **34, 350**
Sale price divided by annual rents. A rule of thumb used to initially evaluate the price of a property.

H

heirs, assigns and successors clause **219**
A clause in a lease agreement which binds those who later take the position of landlord or tenant to the existing agreement. [See **RPI** Form 552 §23.3]

hit-and-run buyers **11**
Flippers who purchase real estate with the intent to quickly resell it at a profit produced by market momentum, not fundamentals.

hold harmless provision **269**
A provision in a lease agreement that shifts liability from the landlord to the tenant for injuries occurring on the premises caused by the tenant's negligence. [See **RPI** Form 552 §15]

I

impasse notice **310**
A notice advising the tenant the lease will expire and no modification of the lease will be entered into.

implicit rent **34**
The value of an owner's use of their property to house themselves or their business.

income approach **33, 348**
The use of a property's rental income to set its value.

income producing property **37**
Residential or commercial income property held by the ownership for the long-term to earn income through leasing operations and price appreciation.

inflation **244**
The price change in consumer goods and services, stated in the consumer price index (CPI) as a figure which is reported as a percentage change over one year ago.

inflation-adjusted rent provision **237**
A rent provision in a commercial lease which calls for periodic rent increases based on changes in inflation index figures during the period. [See **RPI** Form 552 §4.5]

investor **74**
A purchaser who holds a property long-term on a buy-to-let basis as an income producing investment. Contrast with a speculator who buys a property to flip it for profit on a sale, rather than earn annual income from continued ownership.

investment circular (IC) **367**
A disclosure prepared by a syndicator and presented to potential investors explaining the nature of the investment program, significant features of the property selected for acquisition and the risks and financial consequences of the group investment, also known as a prospectus or memorandum. [See **RPI** Form 371]

itemized statement of deductions **197**
A document accounting for the tenant's security deposit, delivered by the landlord to a residential tenant after the tenant vacates. [See **RPI** Form 585 §4.3]

J

John Maynard Keynes **18**
An economist wellknown for his stance that governments need to smooth out the effects of expansion and contraction in the business cycle through fiscal and monetary policy.

joint pre-expiration inspection **192**
An inspection conducted by a residential landlord or the property manager to advise a tenant of the repairs the tenant needs to perform to avoid deductions from their security deposit. [See **RPI** Form 567-1]

L

leasing agent **141**
A broker who markets the availability of space to rent and locates and negotiates the terms of a lease with suitable tenants.

letter of intent (LOI) **76, 166**
A non-binding proposal signed and submitted to a property owner to start negotiations to rent or buy a property. [See **RPI** Form 185]

lender subordination clause **320**
A lease agreement provision which gives a lender with a trust deed interest senior to the tenant's leasehold interest the right to unilaterally subordinate the lender's trust deed to the tenant's leasehold by written notice to the tenant. [See **RPI** Form 552-8 §2]

license **211**
The personal, unassignable right held by an individual to the non-exclusive use of property owned by another.

liquidity trap **6**
A condition in which injections of cash into the banking system by the Federal Reserve fail to stimulate lending and economic growth. In the instance of California's current crisis, cheap cash is sitting in lenders' reserves and not being lent to prospective buyers.

M

mandatory improvement **104**
An improvement required to be made under the terms of the lease or rental agreement.

managing agent **139**
A broker who manages membership, common areas and accounting for a common interest development.

marketing package **74**
A property information package handed to prospective buyers containing disclosures compiled on the listed property by the seller's agent.

material participant **359**
A rental property owner who participates in real estate rental operations or a real estate profession on a regular, continuous and substantial basis.

mechanic's lien **110**
A lien entitling a contractor or subcontractor to foreclose on a job site property to recover the amount due and unpaid for labor and materials they provided.

mixed-use property **43**
An urban real estate development which combines residential and commercial uses.

momentum traders **10**
Buyers relying on the emotion of frenzied market participants, rather than property price inflation, to profit from buying and reselling property.

moral hazard **381**
An investment situation in which the risk of loss is borne primarily by a group of investors, not the syndicator, structured to discourage the syndicator from working for results that exceed minimum performance standards and motivate the syndicator to take unacceptable risks.

N

net income multiplier (NIM) **33**
The property's price as a multiple of the net operating income.

net lease **221**
A commercial lease which transfers to the tenant the obligation, unless modified, to pay all of the costs of ownership in addition to utilities and janitorial services. [See **RPI** Form 552-2 and 552-3]

net operating income (NOI) **24, 75, 379**
The net revenue generated by an income producing property, calculated as the sum of a property's gross operating income less the property's operating expenses and used to determine a property's value and pay mortgage debt. [See **RPI** Form 352 §4]

net sales proceeds **345**
The seller's receipts on closing a sale of their property after all costs of the sale have been deducted from the gross proceeds.

nondisturbance agreement **325**
An agreement with mortgage lender providing for the tenant's lease agreement to remain in effect for its full term after the leasehold is subordinated to a new mortgage.

nondisturbance clause **324**
A lease agreement provision which is coupled with the future subordination clause to allow a tenant's junior leasehold interest to remain unaffected by a lender's foreclosure under a senior trust deed. [See **RPI** Form 552-8]

nonrecurring deposits or charges **163**
One-time costs for which the tenant is responsible. [See **RPI** Form 550 §2]

notice of nonresponsibility **110**
A notice used by a landlord to declare that they are not responsible for any claim arising out of the improvement being constructed on their property. [See **RPI** Form 597]

novation **297**
An agreement entered into by a landlord and tenant shifting responsibility for obligations owed the landlord under a lease agreement to another the tenant, releasing the original tenant of liability.

O

open listing **144**
An employment entered into by a broker to render real estate services on a best-efforts basis under which a fee is due to the broker if they achieve the client's objective of the employment before the client or another broker separately first meet the objective, such as the sale or locating of a property.

operating agreement **367**
A form used by syndicators when setting up a limited liability company (LLC) to establish the procedures for operating the LLC and the rights and duties of its members. [See **RPI** Form 372]

operating expenses **25, 67, 162, 352**
The total annual cost incurred to maintain and operate a property for one year. [See **RPI** Form 352 §3.21]

option period **287**
The specified time period during which the tenant has the right to buy under an option agreement. [See **RPI** Form 161 §4]

option to buy **286**
An agreement granting an irrevocable right to buy property within a specific time period. [See **RPI** Form 161]

option to extend **277, 286**
An agreement granting a tenant the right to extend possession under the original lease agreement on terms set out in the option to extend. [See **RPI** Form 565]

option to renew **277, 288**
An agreement granting a tenant the right to continue in possession upon expiration of the existing lease under a new lease agreement on the same conditions as the expiring lease agreement on terms for payment of rent set out in the option to renew. [See **RPI** Form 565]

overriding rent **296**
The amount the current market rent rates exceed the rents set in the lease agreement, attainable by the tenant on a sublease to a successor tenant.

P

parity distribution **375**
An equal sharing between all members in a limited liability company (LLC) of earnings in the form of spendable income and proceeds of a sale or refinance.

passive income category **356**
Profits and losses from rental real estate, operations and sales, and from non-owneroperated businesses.

percentage lease **226, 253**
A commercial lease agreement for a retail operation that sets the total amount of rent the tenant will pay as a percentage of the tenant's gross sales. [See **RPI** Form 552-4]

permissive improvement **106**
A nonmandatory improvement authorized to be completed by the tenant without further landlord consent.

portfolio income category **359**
Unearned income from interest on investments in bonds, savings, stocks and mortgage notes, and income, profits and losses from management-free income property.

price appreciation **35**
Any increase beyond the rate of consume inflation above the price paid for property experience by the owner on its resale.

profit and loss statement **180**
A type of financial statement which discloses the tenant's business income, expenses and net operating income. [See **RPI** Form 209-2]

property expense profile **167**
An itemized analysis of the costs a tenant or landlord will incur to operate and maintain a particular property. [See **RPI** Form 562]

property management agreement **134**
An employment agreement setting the rights, responsibilities and expectations of both the property manager and the landlord. [See **RPI** Form 590]

property operating data **166**
The actual costs of operating a property for its intended use.

property profile **119**
A report from a title company providing information about a property's ownership, encumbrances, use restrictions and comparable sales data.

prudent investor standard **117**
A property management standard reflecting the expectations of a wellinformed investor for efficient and effective management of rental income and expenses.

purchase agreement **51**
The primary marketing device used to negotiate a real estate sales transaction between a buyer and seller. [See **RPI** Form 150-159]

R

real estate fixture **108**
Personal property attached to the real estate as an improvement, which becomes part of the conveyable real estate.

reasonable certainty **213**
The degree of certainty expected from a reasonable person.

reasonably foreseeable.......... **200**
The possibility a crime or danger may occur due to a previous crime on the premises. A landlord has a duty to take reasonable measures to prevent harm to persons on the property or warning tenants of the prior criminal activity.

recurring operating expenses **163**
The regular and continuing costs of using and maintaining a property.

reformation action **223**
A court action by a tenant seeking to reform the terms of a lease agreement to include prior agreements, oral or written, intended to be part of the lease agreement.

rent **186**
Compensation received by a landlord in exchange for the tenant's use, possession and enjoyment of the property.

rental market **336**
The market environment in which landlords seek tenants and tenants seek landlords for the occupancy of property. The rental market sets the amount of rent a property will command on any given day.

rent provision **259**
A provision contained in a lease agreement establishing the tenant's obligations to pay rents for occupancy and use of the premises leased. [See **RPI** Form 552 §4]

rentier **16**
The class of earners whose income is earned passively, generated from owned tangible and intangible assets rather than through their labor.

reserve account **374**
An account established by a limited liability company (LLC) to cover miscellaneous transactional costs incurred to create the LLC and purchase the property, and for unexpected operating expenses. [See **RPI** Form 371 §13]

restriction-on transfer provision **295**
A provision in a lease agreement calling for either the landlord's consent to any transfer of the tenant's leasehold interest or the prohibition of any transfer of that interest. [See **RPI** Form 552 §9.2]

return of capital **26**
An annual yield on invested capital, stated for group investment purposes as a percentage of equity capital contributed by group members to fund the costs of acquisiton and improvements of a property, represented by the property's net operating income (NOI) less interest paid on mortgage debt, also called return on investment (ROI).

reversion **108**
The conveyance of real estate fixtures from a tenant to landlord on expiration of a lease.

reversionary interest **206**
A landlord's temporarily suspended right to occupy property leased to a tenant for the duration of the lease term.

right of first refusal.......... **286**
A pre-emptive right to buy a property if the owner decides to sell. [See **RPI** Form 579]

right-to-enter provision.......... **266**
A provision contained in a lease agreement which reserves to the landlord the right to enter the leased premises to make necessary repairs, alterations or inspections. [See **RPI** Form 552 §12]

S

safety clause **147**
A provision in an exclusive listing agreement earning the broker a fee during an agreed safety period after expiration of the employment for marketing efforts with identified buyers, tenants or property, if the client sells the listed property to an identified buyer or purchases or leases an identified property during the safety period. [See **RPI** Form 102 §3.1(d), 103 §4.1(c) and 110 §3.1(d)]

security deposit **185**
A source of funds to pay tenant obligations owed the landlord on the tenant's default in the rental or lease agreement.[See **RPI** Form 550 §2.1 and 552 §1.2]

signage provision **263**
A provision in a commercial lease agreement which gives the landlord control over the size, style, content and location of signs constructed or installed on the leased premises. [See **RPI** Form 552 §10]

speculator **74**
A real estate investor who owns property short-term, sandwiching themselves between the seller and end user of the property.

start-up fee **126**
A flat, one-time fee charged by a property manager for the time and effort taken to become sufficiently familiar with the operations of the property to commence management.

statement of deficiencies **195**
A document a residential landlord presents to a vacating tenant specifying any repairs or cleaning to be completed by the tenant to avoid deductions from the security deposit. [See **RPI** Form 567-3]

successor tenant **299**
On a transfer, the new tenant who acquires by assignment the original tenant's entire leasehold interest in the property. [See **RPI** Form 552 §9]

syndication **361**
The activity of a syndicator to bring together a group of investors in coownership formed as a limited liability company to fund the purchase of a propety, and perform property management during ownership and eventually resell the property.

syndicator **362**
An individual who solicits cash contributions from investors to fund a limited liability company which will acquire real estate for investment purposes.

T

Tenant Estoppel Certificate (TEC) **328**
A statement which summarizes the monetary and possessory terms of a lease agreement, and whether the landlord and tenant have fully performed their obligations. [See **RPI** Form 598]

tenant improvements **101**
Improvements made to a rented property to meet the needs of the occupying tenant. [See **RPI** Form 552 §11]

tenant improvements and alterations clause **263**
A clause in a commercial lease agreement which specifies the tenant's right to make alterations or further improve the premises during the tenancy. [See **RPI** Form 552 §11]

tenant lease worksheet **173**
A document the leasing agent uses to analyze the tenant's current financial condition and needs for leased space. [See **RPI** Form 555]

tenant-mitigation provision **303**
A provision in a commercial lease agreement allowing the landlord to leave the tenant's leasehold and the lease agreement intact on the tenant's breach, and then recover rent from the tenant for the life of the lease without the landlord first taking steps to mitigate losses. [See **RPI** Form 552 §21.1]

termination-of agency clause **145**
A provision which assures payment of the broker's fee if the owner cancels the employment without cause before the listing expires. [See **RPI** Form 102 §3.1(c), 103 §4.1(b), 110 §3.1c]

trade fixture **108**
Fixtures used to render services or make products for the trade or business of a tenant.

trade or business income **358**
Income, profits and losses from the taxpayer's trade or owner-operated business, resale inventory and real estate used in the trade or business.

transfer **296**
Any assignment, sublease or further encumbrance of the leasehold by the tenant. [See **RPI** Form 552 §9]

trickle-down economics **18**
The economic theory suggesting that an increase in the strength of the wealthy leads to an increase in the well-being of lower classes.

triple-net lease **268**
A commercial lease which passes the responsibility for all costs and maintenance of the property to the tenant. [See **RPI** Form 552-2 and 552-3]

trust account 116
A bank account used to hold trust funds.

trust funds **126**
Items which have or evidence monetary value held by a broker for a client when acting in a real estate transaction.

U

use-of-premises provision **261**
A provision contained in a commercial lease agreement which establishes the single specified purpose for the tenant's use of the leased premises.

use-maintenance provision **260**
A provision in a commercial lease agreement which establishes the landlord's and tenant's responsibility for the care and maintenance of the premises during the lease term.

W

waste provision **267**
A provision in a lease agreement in which the tenant agrees not to destroy, damage or remove any part of the leased premises. [See **RPI** Form 552 §7.4]

waterbed addendum **341**
An addendum to a rental or lease agreement setting the additional security deposit and insurance coverage the tenant will provide the landlord to keep a waterbed on the premises. [See **RPI** Form 564]

Z

zero lower bound interest rates **6**
Economic conditions characterized by a very low nominal interest rate. As the interest rate is at or near zero, the Federal Reserve (The Fed) cannot lower it further to stimulate the economy without going negative.