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I. Introduction

When a lender begins a foreclosure, parties involved with the property which is the subject of the foreclosure may be uncertain as to how the process affects them. Not only are lenders often unaware of their rights and obligations but borrowers (sometimes also referred to as "owner") who are faced with losing ownership of property also are frequently lacking knowledge about the limit and extent of some of their basic responsibilities and rights. When the foreclosed upon property is a rental, tenants are unwittingly forced into a position of uncertainty concerning their contractual and legal rights and duties. If the rental is managed by a real estate broker, yet another party may feel strained by the tension and possibly competing demands of the property owner, foreclosing lender, and tenant.

This article addresses some of the major issues faced by property owners, lenders, tenants and property managers involved with a foreclosure on rental property. Certain topics will not be addressed, such as the steps in a foreclosure, the circumstances under which a deficiency judgment may be obtained (see Kalin, [Deficiency Judgments and California Law](#), 11 LEaDeR 2 (1993)), and discharge of indebtedness and other issues involved in a short payoff (see legal article, [Short Sales](#)), as these issues are germane to all foreclosure properties. Instead, the primary focus will be to highlight those areas of concern unique to rental properties.

II. Lender Issues

A. Vis a Vis Owner

1. Rent Skimming

Foreclosures typically take place because a borrower does not make required payments pursuant to the loan documents. Foreclosing lenders are bound to be frustrated by an owner who is collecting rents yet not paying a loan. These lenders may want to try and stop the borrower from taking what they perceive as money which is owed to them. After all, isn't this rent skimming? And, isn't rent skimming a crime?

Rent skimming is defined as using revenue received from residential real property any time during the first year after acquiring the property without first applying the revenue to payments due on deeds of trust encumbering the property. (California Civil Code (hereinafter referred to as CC) Section 890.) Criminal penalties of up to one year in jail or up to a ten thousand dollar fine or both exist for rent skimming. (CC Section 892)

But the decision of whether to pursue criminal action is in the hands of a government prosecutor (and outside the scope of this article). What, if anything can the lender do? If rent skimming is involved, a lender can bring a civil action against the borrower for damages, costs, and attorney's fees. The court has the authority to also award exemplary (punitive) damages. (CC Section 891(c).)

If the lender was a seller who carried back a loan and the borrower has engaged in multiple acts of rent skimming, a court must award exemplary damages of at least three times the actual damages. (CC Section 891(a).) The right to bring a claim based on rent skimming is not limited by either the one-action rule or anti-deficiency laws.

2. Before The Foreclosure Sale

a. Mortgagee In Possession

A lender who wishes to enter the property for the purposes of collecting rents may do so with the express consent of the owner/borrower in default even without additional consideration or a formal agreement. (CC Section 2927), (*Hooper v. Young* (1903) 140 Cal. 274.) A lender who does so is a mortgagee in possession. However, a lender who enters the property without the consent, or over the objection, of the owner/borrower in default becomes liable to the owner for forcible entry and trespass. (*California Hotel Co. v. Bank of America Nat'l Trust & Sav. Ass'n* (1939) 31 Cal. App. 2d 295; *Mcguire v. Lynch* (1899) 126 Cal. 576).

The advantage of being a mortgagee in possession is that rents may be collected and applied toward the unpaid debt. On the down side, the lender who becomes a mortgagee in possession is responsible to the borrower and junior lienholder for losses caused by negligence or failure to act in a business-like manner. (*Johns v. Moore* (1959) 168 Cal. App. 2d 709.)

For those who find the advantages outweigh the disadvantages, although not required, a written agreement is advisable in order to avoid conflicts over whether consent was granted or withheld, as well as to have documentation which will support the lender's claim to rents if questioned by tenants.

b. Rents and Profits Clauses

Today, most deeds of trust contain a rents and profits clause. This can be an absolute assignment of rents, an absolute assignment of rents conditioned on default, or an assignment of rents as additional security. This last type of clause is typically found in short form deeds of trust recorded in each county and referred to by a short form trust deed. An example of such a clause appears below:

As additional security, Trustor hereby gives to and confers upon Beneficiary the right, power, and authority, during the continuance of these Trusts, to collect the rents, issues, and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to collect and retain such rents, issues, and profits as they become due and payable. Upon any such default, Beneficiary may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, and without regard to the adequacy of any security for the indebtedness hereby secured, enter upon and take possession of said property or any part thereof, in his own name sue for or otherwise collect such rents, issues, and profits, including those past due and unpaid, and apply the same, less costs and expenses of operation and collection, including reasonable attorneys' fees, upon any indebtedness secured hereby, and in such order as Beneficiary may determine. The entering upon and taking possession of said property, the collection of such rents, issues, and profits, and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice.

The collection of rent pursuant to a rents and profits clause does not, in and of itself, impose mortgagee in possession status on the lender. (*Strutt v. Ontario Sav. & Loan Ass'n* (1972) 28 Cal. App. 3d 866.) The lender must take steps before proceeding to collect. However, a demand upon the tenant or borrower to turn over the rents, coupled with their cooperation is all that is needed. (*Lee. v. Ski Run Apartments Assoc.*, (1967) 249 Cal. App. 2d 293.) If neither party cooperates or if the borrower objects (even if the tenant agrees) the lender needs to file a judicial action for appointment of a receiver.

The legal action is one for specific performance of the borrower's promise as contained in the trust deed. The request for a receiver is secondary to this specific performance action. (Code of Civil Procedure (hereinafter referred to as CCP) Section 564 (b)(8)).) A receiver is an agent of the court,

not the lender and must maintain control of the rents until ordered to pay them out. The order for appointment of the receiver can direct the receiver to apply collected rents:

- (1) First to pay the expenses of the receivership (administrative and management);
- (2) Then to payment of taxes and senior secured debts; and
- (3) Followed by the maintenance of a working capital account before any funds collected are to be made available to the lender. (See, California Mortgage and Deed of Trust Practice, 2nd ed., Roger Bernhardt (hereinafter referred to as "Bernhardt") pp. 259-260.)

Moneys collected by a receiver pursuant to an additional security rents and profits clause can be received by a lender following a trustee's sale without violating either the one-action or anti-deficiency rules. (Bernhardt, *supra* Section 5.22.) In the absence of a rents and profits clause it may still be possible to have a receiver appointed but the burden is much greater on the applying lender than where a rents and profits clause exists. (CCP Section 564(b)(2).)

3. After The Foreclosure Sale

If the borrower occupies one of the units in the rental property and the lender foreclosed judicially, then the borrower is entitled to possession throughout the statutory redemption period (either three months or one year depending on the amount received at the judicial foreclosure). (CCP Section 729.030.) The foreclosing lender can charge the borrower rent for this occupancy equal to the value of use and occupation. (CCP Section 729.090(a).) However, if the occupant/borrower fails to pay rent, the lender probably lacks the ability to evict during the redemption period. After the redemption period, the lender should be able to pursue an action for collection of unpaid rents. (CCP Section 729.090(a).) (Bernhardt, Section 5.37.)

If the lender foreclosed by way of a trustee's sale, the borrower can be evicted immediately following a three day's notice to quit. (CCP Section 1161a(b).)

An owner who is about to lose property through foreclosure is unlikely to either:

- (1) Transfer any security deposits to the foreclosing lender; or
- (2) Return the security deposits to the tenants as is required by law. (Civil Code Sections 1950.5(g), 1950.7(d).)

In the event the borrower does not do either item above, and the rental is residential property, the foreclosing lender is jointly and severally responsible along with the former owner for repayment of any security to which the residential tenant is entitled. (CC Section 1950.5(i).) Possibly this express statement of joint and several liability can be used by the lender to bring a legal action against the borrower for recovery of any sums properly paid to residential tenants for security deposit claims without violating the one action or anti-deficiency rules. (See, also California Real Estate 2d, Miller & Starr, Volume 6, Section 18: 78, ftnt 71, p. 187.)

B. Vis a Vis Tenants

1. Before The Foreclosure

A lender may request that a tenant make payments directly to the lender rather than the borrower in an attempt to create a voluntary exercise of a rents and profits clause or to establish the lender as a mortgagee in possession. The tenant may comply but is not required to do so.

If the lender goes to court and has a receiver appointed with the power to collect rents, a tenant will

be obligated to pay the receiver. There is no apparent right in California law permitting a lender, or receiver, to evict a tenant for a breach of a lease. Indeed, there is a danger in doing so if in fact the borrower reinstates the loan prior to a foreclosure sale and is damaged by the loss of a tenant.

2. After The Foreclosure

If a lender pursues a judicial foreclosure, the tenant, after receiving notice of the sale, must pay rent to the lender or the appointed receiver. (CCP Section 729.090(a), CC Section 1111.) Tenants whose recorded leases are junior to the deed of trust have their leasehold estates remain in effect if omitted from the foreclosure. If included in the legal action, the lease is terminated. Tenants with unrecorded leases, junior to the deed of trust will have their leases terminated even though not named in the foreclosure action. (Bernhardt, Section 5.40.) Nonetheless, tenants whose leases are junior to the deed of trust probably have a right of possession superior to that of the lender during the borrower's redemption period.

If, as in most cases, a lender pursues a trustee's sale, where the lease is senior to the deed of trust (i.e., the lease was recorded before the deed of trust or the lender had knowledge of the tenancy at the time the loan was made), the lender takes the property subject to the rights of the tenant. (CC Section 1107.) The tenant becomes obligated to the lender as if the lender were the former owner. (CC Sections 821, 1111.) When the deed of trust is senior to the tenancy, then the lease may be terminated and the tenant evicted after first being given notice (usually 30 days--60 days per SB 1137 in 2008). (CCP Section 1161a(c) and (d).) The lender who finds that the lease is favorable and wishes to continue to enforce it (CC Sections 821 and 1111) may be disappointed to discover that the tenant has the right to terminate. (*Dover Mobile Estates v. Fiber Form Products, Inc.* (1990) 220 Cal. App. 3d 1494.)

Regardless of the form of foreclosure used, a residential lender becomes obligated to return unused security deposits to any tenants unless the borrower returned these sums to the tenants prior to the transfer of title. (CC Sections 1950.5, (i) and (j).)

Commercial lenders who acquire the property do not have the same statutory obligation to return deposits to tenants if the lender does not receive sums from the former owner (CC 1950.7.) but a foreclosing lender who takes subject to a senior lease or who assumes the benefits of a junior lease will have a difficult time arguing why they should enjoy the lease benefits without being saddled by the deposit burden as well.

III. Owner Issues

A. Vis a Vis Lender

1. Before The Foreclosure Sale

Prior to title transferring at a foreclosure sale, the borrower has a contractual obligation to make the payments specified in the note. Aside from the potential criminal and civil issue of rent skimming, the borrower has no obligation to use the specific rents received to pay off the loan. If the lender wishes to gain access to the property as a mortgagee in possession the borrower can deny the lender permission. (CC Section 2927). Similarly, if the lender attempts to peacefully exercise a rents and profits clause without bringing a judicial action, the borrower can prevent this voluntary exercise by refusing permission and instructing any tenants to continue making payments as called for in the lease and not to the requesting lender.

If the lender brings a legal action to appoint a receiver to enforce a rents and profits clause, the borrower can oppose the action. The appointment of a receiver is discretionary, not automatic. (CCP Section 564(b)(8).) Where a rents and profits clause does not exist and the lender applies to the court for appointment of a receiver, the borrower may defeat the action by showing the following:

- (1) The property is in no danger of being lost, removed, or materially injured; or
- (2) That even if a condition has not been performed, the property is sufficient to satisfy the debt. (CCP Section 564(b)(2).)

2. After The Foreclosure Sale

Upon termination of the borrower's interest in the property, security deposits which are not returned to a tenant should be transferred to the borrower's successor in interest, the lender. (CC Sections 1950.5 (g), 1950.7(d).) In the event the owner fails to comply with this requirement, and the rental is residential, the owner remains jointly responsible with the lender for repayment of security to the tenant. (CC Section 1950.5(i).)

In the event the borrower occupies one of the units and the lender proceeds judicially, the borrower can remain in possession following the sale for the redemption period but owes rent for this occupancy. (CCP Section 729.090(a).) If the lender forecloses non-judicially (trustee's sale), or if a judicial foreclosure is followed, and deficiency judgment is waived or prohibited, the borrower is subject to an immediate unlawful detainer after receiving a three-day notice. (CCP Section 1161a (b).)

B. Vis a Vis Tenant

1. Before The Foreclosure Sale

The borrower is contractually entitled to receive rent from the tenant even though in default on the note. A default on the note, in and of itself, does not create a breach of the covenant of quiet enjoyment of the leased premises or a denial of possession to the tenant. Thus, the tenant who ceases payment of rent can be evicted by the owner or sued for breach of the lease. (CCP Section 1161.)

2. After The Foreclosure Sale

Upon sale, the owner must return the security deposit to the tenant or transfer it to the foreclosing lender in order to be relieved of liability for the security deposit to the tenant. (CC Sections 1950.5 (g), 1950.7 (d).) The borrower who has not taken one of the steps above and who in bad faith fails to return a security deposit to a tenant can be held liable to the tenant for up to \$200 in commercial leases (\$600 in residential leases) in addition to actual damages. (CC 1950.5 (k), 1950.7 (f).)

IV. Tenant Issues

A. Vis a Vis Owner

1. Before The Foreclosure Sale

Once a tenant learns a property owner is in default, the tenant may have a tendency not to pay rent due the owner. While the owner can bring an unlawful detainer for failure to pay rent, the legal action must follow a three-day notice to pay rent or quit. (CCP Section 1161.) Thus, a tenant may decide to take the risk to violate the lease knowing that at worst it will be given a chance to correct the violation before any legal action can proceed. As stated in the previous section, a landlord's default on the note is probably in and of itself not a breach of the covenant of quiet enjoyment or interference with the tenant's right of possession so as to give the tenant a valid claim for withholding rent. If an owner consents to a lender's acting as a mortgagee in possession or authorizes the lender to accept rents without filing a legal action for specific performance of the rents and profits clause, the tenant can cooperate but should get the owner's consent in writing as a precautionary measure.

2. After The Foreclosure Sale

Upon termination of the lease, the tenant can hold the former owner responsible for return of any unused security deposit monies (CC Section 1950.5 (g), 1950.7 (d)), unless the owner returned the security to the tenant upon transfer of title or unless the owner had transferred the security deposit to the lender and had notified the tenant of the transfer. The notice can be delivered in person or by first-class mail. If delivered personally, the tenant has the responsibility to sign both an acknowledgement of receipt of the notice and the landlord's copy of the notice. (CC Sections 1950.5 (g) (1), 1950.7(d)(i).)

B. Vis a Vis Lender

1. Before The Foreclosure Sale

The tenant has no obligation to comply with a lender's request that rent payments be made direct to the lender rather than the owner. However, once a receiver has been judicially appointed the tenant would be required to honor the rent demands of the receiver as an agent of the court.

2. After The Foreclosure Sale

The tenant is responsible to the lender for payment of rent from the time the tenant has been informed of the transfer. (CC Sections 1111, 821.) The lender may also bring claims against the tenant for breach of the lease. If a residential tenant has not had the security deposit returned upon transfer of the title, the tenant is entitled to return of the security deposit from the lender upon termination of the lease. The bad faith claim or retention by such a lender of the security deposit would allow the residential tenant to also pursue additional sanctions of up to \$600. (CC Section 1950.5 (g), (i), (k).) A commercial tenant can hold the successor owner (lender) responsible for the security deposit if the deposit was transferred to the lender.

The tenant of a lease junior to the foreclosing lender's deed of trust may be evicted upon notice (typically 30 days). (CCP Section 1161a (b), (c), (d).) On the other hand, a junior tenant with an unfavorable lease can terminate the lease upon giving the lender 30 days notice. (*Dover Mobile Estates, supra.*)

V. Property Manager Issues

A. Vis a Vis Owner

Prior to a foreclosure sale, the property manager has contractual and fiduciary obligations to the owner of the property. If the management agreement provides for the collection of rent, then such activity, consistent with the terms of employment, is done on behalf of the owner. Honoring a request of the lender for disbursements of rents received, without the express permission of the owner would be grounds for breach of the manager's contractual and, possibly, fiduciary duties. The default of the owner does not entitle the manager to neglect responsibilities identified in the property management agreement.

Once a receiver has been appointed, if the power of appointment directs the manager to hand over received rents, then the request of the court appointed representative should be satisfied. If the receiver collects rents directly, and takes over other management functions from the property manager, this would have the effect of terminating the agency and contractual obligations of the manager and establishes probable grounds for a manager's breach of contract claim against the owner. Moneys held by the manager should be disbursed in accordance with the instructions of the owner unless directed otherwise by a receiver who has been granted that authority.

After the foreclosure sale, the subject of the agency - the owner's interest in the real property -

becomes extinct, thus terminating the agency. (CC Section 2355.) As a consequence, the owner may be liable to the property manager for breach of contract damages. However, disbursement of previously collected sums still requires direction from the former owner or court.

B. Vis a Vis Lender

The property manager is the agent of the owner and has no obligation to honor any request for disbursement of rents made by a foreclosing lender. Upon receiving such a request, that agent's duty of full disclosure would impose upon the manager a requirement to inform the owner of the lender's request. If a lender has a receiver appointed, the manager can presumably enter into an agreement with the receiver to continue performing property management functions, for a fee. Such an agreement would affect rents collected and services performed after the date of the agreement.

After the foreclosure sale terminates the owner's interest in the property and the agency relationship between the owner and manager, the manager may enter into a new property management agreement with the lender, just as the manager could with any owner of property. Should the lender demand that the manager release previously held tenants' security deposits, the manager should refuse. These funds are held in a trust account for the benefit of the former owner and are not the property of the manager (Business & Professions Code Section 10145, 10176(e).)

C. Vis a Vis Tenants

One issue facing a property manager is whether to inform tenants that the property owner is in default and facing foreclosure. One could argue that the information is material and, accordingly, should be disclosed. After all, a fixed term lease may be terminated if the foreclosure is completed. (CCP Section 1161a.) On the other hand, the owner may fear that once armed with this information, tenants will stop paying rent, depriving the owner of the still valid contractual right to collect money for leasing the property. Also, if the leases are superior to the foreclosing lender's trust deed, then the leases remain intact even after a foreclosure sale. If the leases are month-to-month, the foreclosure sale does not change the nature of the tenancy anyway and, it could be argued, that the foreclosure is not material. However, the tenant could argue that the new landlord's ability to respond to tenant complaints and issues may be different from the current owner's and thus is material. Furthermore, if security deposits are not transferred, the tenants' rights are also affected. The landlord can argue that the tenants' concerns are speculative since the owner has the right to cure the default and reinstate the loan up to five days before the foreclosure sale date. (CC Section 2924c (e).)

What should the manager do? If during the lease negotiations the manager acted as a dual agent, then the manager's fiduciary responsibilities would require disclosure of the foreclosure. If there were no agency with the tenant or if the lease was already in place when the agent became the property manager, then the manager should first seek permission to disclose the fact of the foreclosure to uninformed tenants.

Once the foreclosure sale has been completed, tenants whose leases have terminated and who desire a return of their security deposits might try to sue the manager. If the lease was signed by the former owner or the deposits are held in a broker's trust account, the tenant will have difficulty establishing a claim against the manager. But if the manager has signed the lease or the deposits are held in the broker's own account, then the manager appears to be acting as a landlord and not just a representative of the former owner. Tenants with disadvantages junior leases may wish to exercise their legal option to terminate the lease. The manager then has an opportunity to make a commission by negotiating a new lease between the new owner (lender) and tenant.

VI. Conclusion

Unfortunately, many areas of the state are experiencing record levels of foreclosures. REALTORS®

in these areas, as well as anywhere else where a foreclosure is occurring, are often asked questions by the principals involved with the property. Owners, lenders and tenants of rental property in foreclosure who are, have been or anticipate having a working relationship with a REALTOR® may seek advice from the real estate licensee. While a licensee should avoid giving legal advice, it is helpful for a REALTOR(R) to have an understanding of some basic issues facing these principals. Such an understanding can help guide the REALTOR® away from problems and toward solutions.

When a rental property is being foreclosed upon, the duties and relationships between and among the principals and agents change depending on the strategies employed by the foreclosing lender, the needs and desires of the property owner, and the type and priority of the tenants' leases. Another critical factor affecting the relationships is whether or not the default has resulted in an actual sale of the property. This article has identified many of the issues most likely to be faced by a real estate licensee. The purpose is to enable a REALTOR® to identify issues and problems so that appropriate steps can be taken, or appropriate referrals made, to enable the principals and REALTORS® alike to make their way through a difficult situation with as much information and ease as possible.

NOTE: This article may be cited as: Kalin, *Foreclosing On Rental Property*, 1994-1 LEaDeR 3 (1994).

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The information contained herein is believed accurate as of August 1999. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney.