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Your Rental Unit is in Foreclosure

Now What?

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An estimated 10 percent of all homes in the United States are in the process of being foreclosed upon. But tenants are suffering from foreclosure as well. But what are the rights and responsibilities of tenants when their landlords lose the property to foreclosure? Tenants should focus on a few central concerns (that are conversely concerns of either the foreclosing lender or the former owner):

- The tenant's right to possession
- The requirement to pay rent
- The disposition of the tenant's security deposit
- The tenant's rights against the foreclosed-out owner

1. THE TENANT'S RIGHT TO POSSESSION

a. Extinction of the junior tenancies after foreclosure

Foreclosing upon a lien, including a mortgage or deed of trust—which can be called a mortgage for these purposes—extinguishes any junior lien. See *Dover Mobile Estates v. Fiber Form Products* (1990) 220 Cal.App.3d 1492, 1498; see *Aviel v. Ng* (2008)161 Cal.App.4th 809, 816 (mortgages and deeds of trust substantially identical). A lease is a lien, so that foreclosure extinguishes all junior leases. *Ibid.* Leases entered into before the mortgage, on the other hand, are senior to it and survive foreclosure so long as the lender had actual or constructive notice of them. *Ibid.*

As a practical matter, few long-term renters have an advantage over the foreclosing bank. Most residential tenants who have been on the property that long have month-to-month tenancies. Civil Code section 1942.1 does require a 60-day notice to terminate a month-to-month tenant who has lived on the property for more than a year. But other statutes give most foreclosed-on residential tenants a right to remain on the premises for that long or even longer, no matter the length of their tenancy.

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Nor will most commercial tenants with long term-leases have a right to remain on the premises after a foreclosure under a later mortgage. Those leases probably have a provision subordinating the tenants' interests to those of anyone later lending on the property. See *Aviel v. Ng, supra*, 161 Cal.App.4th at 816. A subordination agreement is a contract by which a party holding a senior lien or other real property interest agrees to lower its priority in relation to that of another holding an interest in the same property. *Ibid.*

Long ago, the California Supreme Court held that the foreclosure of a mortgage ended not just the leasehold but the lessee's right of possession. *McDermott v. Burke* (1860) 16 Cal. 580, 589. "There is no privity of contract or of estate between the purchaser upon the decree of sale and the tenant. The purchaser may, therefore, treat the tenant as an occupant without right, and maintain ejectment for the premises." *Ibid.*

b. Notice to the tenant before eviction

Code of Civil Procedure § 1161a allows the buyer at a foreclosure sale to bring an unlawful-detainer action against the mortgagors or their tenants following service of a notice to quit. *Duckett v. Adolph Wexler Building & Finance Corp.* (1935) 2 Cal.2d 263, 265. As originally enacted, the statute required only a three-day notice. See id.., subd. (b)(2), (3). It allows the buyer to give a three-day notice mortgage after foreclosure of a mortgage (subd (b)(2)) or deed of trust (subd. (b)(3)) to the one who executed it—generally the property owner—and to anyone who claims a right to possession under that person. The most obvious example of one claiming under the one who executed the deed of trust would be a tenant.

Subdivision (c), on the other hand, requires a thirty-day notice to a tenant of a "rental housing unit" who has leased the "rental housing unit either on a periodic basics from week to week, month to month, or other interval, or for a fixed period of time." The statute defines "rental housing unit" as "any structure or any part thereof which is rented or offered for rent for residential occupancy in this state." Code Civ.Proc. § 1161a(d). Any residential tenant paying rent for the premises thus needs thirty-day notice.

Subdivision (c) of section 1161a excludes three types of persons who generally have the protection of California's unlawful-detainer laws. First, by its terms it applies only to residential tenants, thus excluding purely commercial tenants. Second, it excludes tenants at will, to whom the buyer may still give a three-day notice. See Civ. Code § 789. An at-will tenancy arises when the tenant takes possession with the landlord's permission but for no stated term and without any agreement about paying rent. *Covina Manor v. Hatch* (1955) 133 Cal.App.2d Supp. 790, 793. Because tenants at will do not occupy the premises either from month to month or for a fixed period, . § 1161(a) excludes them.

Finally, § 1161a(c) by its terms applies only to tenants. It thus excludes any application to licensees. A tenant differs from a licensee in that a tenant has the exclusive right to possess the property exclusively against the whole world, including the owner. *Spinks v. Equity Residential Briarwood Apartments* (2009)171 Cal.App.4th 1004, 1040. A license, on the other hand, is a nonpossessory parivilege to use another's real property. Ibid. For example, renters of rooms in a house who have use of the kitchen and other living areas are licensees.

Unlike other statutes governing tenancies, nothing in § 1161a(c) includes lodgers and boarders as tenants. Cf. Code Civ.Proc. § 1161, last paragraph (under that section, a "tenant" means any hirer of real property); Civil Code § 1940(a) (lodgers and boarders along with tenants are "hirers of real property"). They therefore have no right to stay in the premises after foreclosure beyond the three days that section 1161a(b) extends to the homeowners. A buyer does not have to worry about bringing an unlawful-detainer action based on a three-day notice upon the occupying former owner only to find that a boarder requiring thirty-days notice also lives there.

Both the California Legislature and the United States Congress has extended the time in which the mortgagor's tenant may continue to live on the premises after foreclosure. In July 2008, the Legislature enacted Code of Civil Procedure section 1161b, which requires 60-days notice to quit for rental housing units. The statute does not apply if persons who are parties to the note remain on the premises. Code Civ. Proc. § 1161b(b). In 2010, the Legislature added section 1161(c), which requires any notice to quit under section 1161b to have a cover sheet explaining the procedure for eviction. If the notice to quit gives at least 90 days notice, the notice itself may state the required information, without the necessity of a cover sheet. Id., § 1161c(c).Both section 1161b and section 1161c will expire by their own terms on January 1, 2013. Id., §§ 1161b(c), 1161c(d).

Congress has responded to the foreclosure crisis by mandating 90-days notice to many residential tenant in the Protecting Tenants at Foreclosure Act of 2009, or "PTFA." See Pub L. 111-22, title VII, § 702, 123 US Stat. 1660-1661. (PTFA is uncodified, but West and Lexis both have reproduced it in their notes to 12 U.S.C. § 5220). Under subdivision (a) of PTFA, "[i]n the case of any foreclosure on a federally-related mortgage loan or on any dwelling or residential real property after the date of enactment of this title [May 20, 2009], any immediate successor interest in such property pursuant to the foreclosure shall assume such interest subject to" giving 90-days notice to a "bona fide tenant."

PTFA is a federal statute that no federal court will ever interpret. It only gives directive to state courts. *Fannie Mae v. Lemere* (E.D. Cal., No. CIV S-10-1474 MCE GGH PS, July 6, 2010), 2010 U.S. Dist. LEXIS 67005, at *5 The courts have universally limited it to creating a defense for the tenant. See, *e.g., BDA Inv. Properties LLC. v. Sosa* (C.D. Cal., No. CV 11-01876 GAF (Rzx) April 5, 2011) 2011 U.S. Dist. LEXIS 54524, at *6-7. It thus does not create a private right of action or support removal to federal courts. *Ibid.*.

PTFA's terms require definition. First, it governs foreclosures "on a federally-related mortgage loan or on any dwelling or residential real property after" May 20, 2009. The term "federally-related mortgage loan" under the Act as it does in section 3 of the Real Estate Settlement Procedures Act of 1974 ("RESPA"). RESPA has two requirements for federally-related mortgage loans. 12 U.S.C. § 2602(a), (b). First, it must be secured by a first or subordinate lien on residential real property designed principally for the occupancy of from one to four families. *Id.*, subd. (a). The secured property, not the entire building, must be so designed; the term specifically includes loans on individual condominium units. *Ibid.*

RESPA then contains four alternative requirements for federally-related mortgage loans. 12 U.S.C. § 1202(b). The first three seem quite technical, but probably apply to bank loans and only bank loans. For example, the first alternative is that they are made in whole or in part by any lender with federally insured deposits or by any federally regulated lender. *Id.*, subd. (b)(i).

The fourth alternative includes as federally-related mortgage loans those loans made in whole or in part by any "creditor" under the Truth in Lending Act ("TILA") who makes or invests in residential real estate loans aggregating more than $1,000,000 per year. *Ibid.* Under TILA, a "creditor" regularly extends consumer credit either payable in more than four

installments or subject to a finance charge. 15 U.S.C. § 1602(f)(1). The "creditor" must be the person to whom the money is payable on the agreement's face. *Id.*, subd. (f)(2). Showing that a TILA "creditor" made the foreclosed loan may require significant discovery by the tenant in an unlawful-detainer action.

One trial court has pointed out that, as written, the PTFA's language "on any federally-related mortgage loan *or* on any dwelling . . ." (emphasis added) effectively extends the statute's reach beyond those mortgages that the federal government has guaranteed or subsidized. *Collado v. Boklar* (N.Y.Dist.Ct. 2009) 892 N.Y.S.2d 731, 734. A literal construction would exceed Congress's constitutional authority. *Ibid.* The court deemed the first *or* a scrivener's error, so that the statute should read, "'federally related mortgage loans on any dwelling . . ..'" *Id.*, at 735-736.

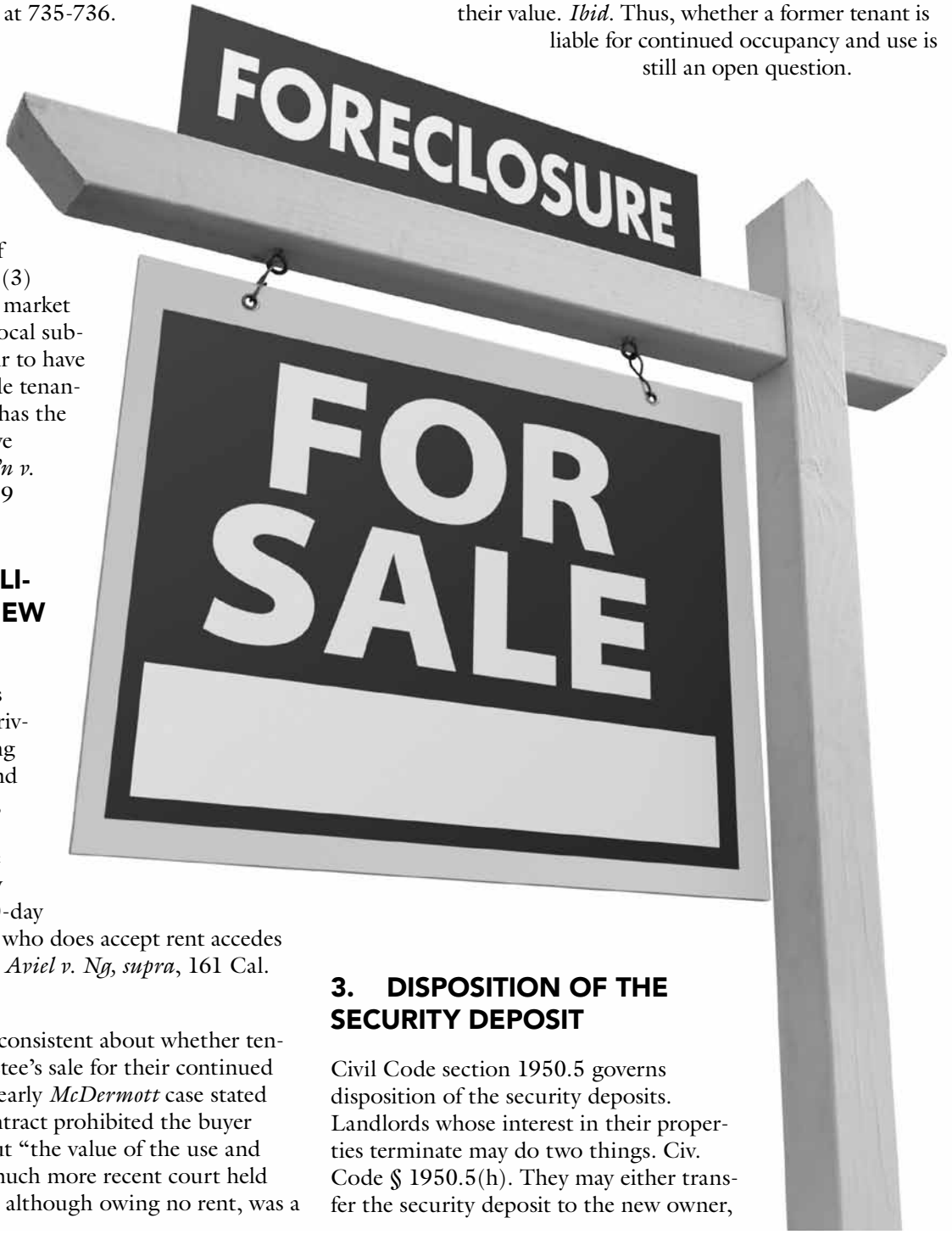
Finally, the Act protects only "bona fide tenants," which it defines in subdivision (b). A tenant is bona fide only if (1) the tenant is not the mortgagor or the mortgagor's child, spouse, or parent, (2) the lease or tenancy was the result of an arms-length transaction; and (3) the tenant pays substantially fair market rent, unless a Federal, State, or local subsidy reduces it. The tenant appear to have the burden of proving a bona fide tenancy, just as the defendant usually has the burden of proving any affirmative defense. See *U.S. Bank Nat. Ass'n v. Hurtado* (N.Y.Dist.Ct. 2010) 899 N.Y.S.2d 806, 808.

2. THE TENANT'S LIABILITY FOR RENT TO THE NEW OWNER

Because foreclosure extinguishes junior leases, the buyer has no privity of contract with the occupying former tenant and cannot demand rent. *McDermott v. Burke, supra*, 16 Cal. at 589. The buyer therefore cannot evict a tenant on the basis of a three-day notice to pay rent or quit before the 90- or 60-day notice period expires. An owner who does accept rent accedes to a new month-to-month lease. *Aviel v. Ng, supra*, 161 Cal. App.4th at 820.

California courts have not been consistent about whether tenants must pay the buyer at a trustee's sale for their continued occupancy of the property. The early *McDermott* case stated that the absence of privity of contract prohibited the buyer from demanding not just rent but "the value of the use and occupation." 16 Cal. at 589. A much more recent court held that the tenant after foreclosure, although owing no rent, was a tenant at sufferance and thus, like a holdover tenant, was liable for the reasonable value of occupying the property. *Aviel v. Ng, supra*, 161 Cal.App.4th at 820. The *Aviel* court did not cite *McDermott.* The case it did cite for the rule that the tenant after foreclosure was a holdover tenant, *Principal Mutual Life Ins. Co. v. Vars, Pave, McCord & Freedman* (1998) 65 Cal. App.4th 1469, 1478, stated it only in dictum as part of a general discussion about foreclosure's effect on tenants. The *Principal Mutual Life* court in turn cited *Dover Mobile Estates v. Fiber Form Products, supra*, 220 Cal.App.3d at 1498, which said nothing about holdover tenants or tenancy at sufferance.

The tenants in *Aviel* did not dispute that they owed for occupancy and use after foreclosure. 161 Cal.App.4th at 820. Instead, they insisted that the lease, rather than the market, determine their value. *Ibid.* Thus, whether a former tenant is liable for continued occupancy and use is still an open question.



3. DISPOSITION OF THE SECURITY DEPOSIT

Civil Code section 1950.5 governs disposition of the security deposits. Landlords whose interest in their properties terminate may do two things. Civ. Code § 1950.5(h). They may either transfer the security deposit to the new owner,

notifying the tenant of doing so (*Id.*, subd. (h)(1)), or they may transfer it to the new owner. *Id.*, subd. (h)(2). If the landlord fails to do either, the former landlord and the new owner are jointly and severally liable for the deposit. *Id.*, subd. j. The new owner cannot demand a new security for any amount either withheld by the old owner or delivered to the tenant without first restoring any amounts unpaid to the security or provide the accounting of the security's disposition that a landlord ordinarily must provide after the tenancy ends. *Ibid.*, see *id.*, subd. (g).

Before delivering the security deposit to the new owner or to the tenant, the former landlord may make lawful deductions, as stated in section 1950.5(e). Civ. Code § 1950.5(h)(1), (2). Subdivsion (e) allows the landlords to claim from the security amounts reasonably necessary for the purposes specified in subdivision (b): unpaid rent, damages that the tenant causes, and cleaning after the tenancy ends. By its terms, the landlord cannot deduct for cleaning after the tenancy ends, since the tenants are still in possession. But subdivision (h) allows the old owners to deduct for damages that the tenant caused, even though they involuntarily lost the house and anything that the tenant did to it no longer concerns them.

4. THE FORMER LANDLORD'S LIABILITY TO THE TENANT

A landlord who allows leased premises to go into foreclosure, resulting in the tenant's eviction, breaches the lease's implied covenant of quiet enjoyment. *Stillwell Hotel v. Anderson* (1935) 4 Cal.2d 463, 467; Civ. Code § 1927. Civil Code § 3304 facially governs damages for breach of the covenant of quiet enjoyment, but it does not apply to evictions of lessees. *Standard Livestock v. Pentz* (1928) 204 Cal. 618, 638. Instead, the foreclosed-out tenant may recover for loss of use of the premises, less unpaid rent, under Civil Code § 3300. Id., at 641-642. The tenant may also recover any other damages naturally and proximately resulting from the eviction. *Stillwell Hotel v. Anderson*, 4 Cal.2d at 469. Those other damages could include the cost of defending possession against the new owner *(Standard Livestock v. Pentz*, 204 Cal. at 632-633), moving expenses (*Klein v. Lewis* (1919) 41 Cal.App. 463, 467-468) and lost profits. *Cappuccio v. Tufts* (1930) 109 Cal.App. 274, 278.

A landlord who shows bad faith by renting premises knowing foreclosure to be likely faces "substantial damages." *Standard Livestock v. Pentz*, 204 Cal. at 633-635. The *Standard Livestock* court did not suggest what the elements of those "substantial damages" might be. Arguably such bad faith constitutes malice supporting an award of punitive damages. See Civ. Code § 3294(c)(1).

No court in California, nor apparently anywhere else, has determined which statute of limitations applies to the breach of quiet enjoyment. Whichever does apply, it begins to run at the tenant's eviction, not at foreclosure. *Standard Livestock* 625-626.

CONCLUSION

Landlords ordinarily lose their rental properties to foreclosure because they do not have money, so a tenant's action for damages may not do much good. The landlord may not even be able to come up with the tenant's security deposit. Foreclosed-out tenants will generally be most concerned about when they must move and what, if anything, they must pay. Through . § 2012, most residential tenants will require 90-days notice under federal law. Other residential tenants will still require 60.

Unless either Congress or the Legislature extends the law, beginning in January 2013, residential tenants will require 30-day notices. Foreclosed-out tenants owe no rent to the new buyer. Whether they have to pay the reasonable value of their occupancy is still an open question.