



A Subsequent Owner Is Liable for Prior Owner's Violations of Rent Control Ordinance

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Prospective owners and, in the current foreclosure climate, financial institutions should be aware of *Baychester Shopping Center, Inc. v. San Francisco Residential Rent Stabilization and Arbitration Board*, 165 Cal.App.4th 1000 (2008). In a case arising out of the San Francisco rent control ordinance, a court held a current owner of an apartment building liable for rent overpayments relating back to the ownership period of a prior owner. Although certain details of the case are unique to the San Francisco rent control ordinance, purchasers should perform due diligence on rent control and inclusionary housing ordinances and negotiate for adequate representations and, if necessary, post-closing security on such representations.

The Case

In late 2005, Baychester Shopping Center (Baychester) contracted to buy a 9 unit residential apartment building. In October 2005, a tenant, who had lived there since 1991, filed a claim with the San Francisco Residential Rent Stabilization and Arbitration Board (Board). The tenant claimed that his rent had increased more than was allowed under San Francisco's rent control ordinance, which is administered by the Board. In December 2005, Baychester closed on its purchase of the building. In February 2006, an administrative judge determined that the tenant had been overcharged and ordered Baychester to repay the tenant. Baychester appealed, first to the Board, then to the San Francisco Superior Court and finally to the California Court of Appeals.

The Appellate Court initially pointed out that the San Francisco rent control ordinance specifically made successor landlords responsible for rent increases that violate the ordinance. The Court then rejected Baychester's arguments that it was not responsible for its predecessor's rent increases, determining that:

- Civil Code § 1466, which releases subsequent property owners from violations of covenants running with the land, does not apply to a the rent control ordinance;

- Baychester's due process rights were not violated as the rent control ordinance is rationally related to a legitimate public policy interest; and
- A prior case rejecting successor landlord liability under the San Francisco rent control ordinance (for failure to provide heat) did not apply to provisions involving rent increases rather than a failure to provide critical utilities.

Lessons for Purchasers

As explicitly stated by the *Baychester* Court, it is incumbent upon purchasers to perform due diligence on rent control ordinances, including the following steps:

- Find out if the property is subject to either rent control or inclusionary housing ordinances, which generally require a certain number of units within a newly-constructed building to be set aside for affordable housing. Some jurisdictions, such as the City of Los Angeles, will issue a letter stating whether a building is subject to rent control.
- Analyze the rent roll and tenant files to determine whether all rental increases comply with applicable rent control or inclusionary housing ordinances.
- Contact any applicable local housing department to obtain as much information as possible about the property, such as whether any tenant has filed any complaints to rental boards (it was unclear whether Baychester knew before closing that the tenant had filed a case with the Board).
- Consider requesting estoppel certificates from tenants relating to any potential rent control or other violations. Although such certificates are not typical in residential transactions and would probably not bar future claims by those tenants, they could certainly alert the purchaser to pending or potential claims and a tenant with claims is more likely to respond than one without.

The *Baychester* case did not discuss either any representations in the purchase agreement or indemnities from Seller. Potential purchasers should consider obtaining representations or indemnities that cover liability for the seller's conduct as a landlord under rent control and similar ordinances, and either verify that the seller is adequately capitalized to honor its obligations in the case of a breach of representation or liability under an indemnity, or require an adequate holdback. A key difficulty will always be having a representation or indemnity survive long enough to provide coverage for issues which arise.

Lessons for Lenders

Given the recent spate of foreclosures on multi-family residential buildings in California, lenders are advised to heed the *Baychester* case. The San Francisco rent control ordinance is broad enough to include all successors, which would include lenders and purchasers at foreclosure sales. Lenders may want to include due diligence activities similar to those advised for purchasers above as part of the underwriting process. Lenders may want to include responsibility for rent control violations within a guaranty agreement, which should, if properly drafted, survive a foreclosure. Regardless of any pre-foreclosure strategy used by a lender, it will want to consider whether any violations or filings exist as of the time foreclosure is proposed and determine whether a delay in foreclosure is warranted.

Summary

Many potential purchasers and lenders of residential property think they have limited or no liability for actions of a predecessor. The recent *Baychester* case held precisely the opposite: successor landlords *may be* responsible for unlawful rent increases of their predecessors. Potential purchasers and lenders should perform due diligence that includes the effect of rent control and inclusionary or affordable housing ordinances and to adopt adequate contractual means to protect themselves post-closing.

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