

2009-2010 Update Course

SECTION TWO

SELECTED PROPERTY MANAGEMENT ISSUES

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LEARNING OBJECTIVE: This section will review the licensing requirements for individuals who are managing or leasing properties for others, as well as state laws pertaining to residential tenant security deposits which apply to *all* residential landlords. It will also discuss a broker's obligations regarding the trust monies s/he receives and disburses, namely, the rents and tenant security deposits.

INTRODUCTION

In response to a request from a considerable number of licensees engaged exclusively or primarily in **residential property management**, the Commission plans periodically to include in the *Real Estate Update Course* some instruction on issues of particular interest to licensees engaged in residential leasing. The Commission notes that although a relatively small segment of the licensee population is engaged exclusively in residential property management, many licensees are involved in residential leasing on a part-time or at least occasional basis. Consequently, a substantial number of licensees will benefit from this instruction.

This section will first briefly discuss who needs a license to engage in property management, and will then **review the legal requirements relating to the handling of rents and tenant security deposits.**

LICENSING REQUIREMENT FOR PROPERTY MANAGERS

Who needs a license to engage in property management? To answer that question, one must first ask, what is meant by the use of the term “property manager?” If “property manager” is used in the sense of the persons/entity who is/are responsible for custodial, janitorial, maintenance and repair type issues affecting the property (a caretaker?), then such person would not need a license as the services have nothing to do with brokerage activity.

If, however, by “property manager” one means a person who as an agent of a property owner oversees the showing and leasing of units or space and collects the periodic rent payments and any tenant security deposits and perhaps pays some of the expenses associated with the property and remits the net proceeds to the owner monthly, for which services the person is compensated, then that is brokerage activity and **the person or entity entering into the written management/leasing agency agreement with the property owner must hold an active North Carolina broker license.**

NOTE: *A property management agreement between a broker and a property owner must be in writing from the outset of the relationship prior to the broker providing any services.* While it must state a date on which it automatically terminates, it may also contain a clause allowing “... automatic renewal so long as the landlord may terminate with notice at the end of any contract period and any subsequent renewals.” For example, the original agreement states that it is for a one-year period and will terminate at midnight on August 31, 2008, but will automatically renew for an additional one year term each year on the anniversary date, unless the owner notifies the agent in writing in August of any given year that the owner elects to terminate the management agreement. The agreement also must contain the fair housing non-discrimination language set forth in Rule A.0104(b).

Licensing Exception for Certain Salaried Employees of a Broker - Property Manager

Lastly, brokers who engage in property management should be aware that, unlike sales transactions where all agents must have an active broker license, the General Assembly created a narrow exception which allows *brokers* engaged in leasing/property management to hire unlicensed salaried (i.e., W-2) employees to assist with the leasing activity. What these unlicensed W-2 employees may do is found in the statute. [G.S.93A-2(c)(6).] This exception states that the licensing requirement shall not apply to:

...Any salaried person employed by a licensed real estate broker, for and on behalf of the owner of any real estate or the improvements thereon, which the licensed broker has contracted to manage for the owner, if the salaried employee is limited in his or her employment to: exhibiting units on the real estate to prospective tenants; providing the prospective tenants with information about the lease of the units; accepting applications for lease of the units; completing and executing preprinted form leases; and accepting security deposits and rental payments for the units only when the deposits and rental payments are made payable to the owner or the broker employed by the owner. The salaried employee shall not negotiate the amount of security deposits or rental

payments and shall not negotiate leases or any rental agreements on behalf of the owner or broker. [All emphasis added.]

NOTE that *only W-2 employees of a licensed broker who has been hired to manage property for others will qualify for this exception.* Unlicensed property owners may NOT pay unlicensed persons who have no ownership interest in the property to assist them in leasing or managing property they own, even if such persons are related to the property owner.

The broker-property manager must adequately train and supervise all of his/her/its employees and may be held accountable for his/her/its employees' conduct. As a practical matter, this duty falls on the appropriate **broker-in-charge**. For a sole proprietorship, the broker-owner will also be the broker-in-charge. For a firm, the designated broker-in-charge of the firm will have the primary responsibility for the firm's duty to train and supervise affiliated licensees and unlicensed employees assisting with property management activities. All employees should be extremely well trained in fair housing issues, ADA compliance, and in the broker's trust money procedures. Understand as well that unlicensed employees are *not permitted to negotiate* issues such as rental amount, partial payment of tenant security deposit, etc. Such issues must be referred to the broker. The salaried employees may only operate within the parameters established by law and by the broker. These unlicensed salaried employees may be onsite at an apartment complex the broker has agreed to manage, or may be showing single family homes the broker has listed for lease *to prospective tenants*.

Brokers (whether an individual broker or a firm) are subject to disciplinary action for their employees' conduct *when "the broker's unlicensed employee, who is exempt from the provisions of this Chapter [93A] under G.S. 93A-2(c)(6), has committed, in the regular course of business, any act which, if committed by the broker, would constitute a violation of G.S. 93A-6(a) for which the broker could be disciplined..."* [See G.S. 93A-6(b)(4).]

Query: Must each managed location with unlicensed employees have a broker-in-charge?

The broker/firm that employs unlicensed salaried employees has a principal office with a broker-in-charge somewhere. But what about the apartment complexes the broker/firm manages? Clearly there is an office at each complex to which the tenants come to pay their rent, inquire about availability, register repair requests, etc. Must each office at each apartment complex have a broker-in-charge?

Rule A.0110(b) defines an "**office**" as "*...any place of business where acts are performed for which a real estate license is required ...*" If all the services provided at the apartment complex locations fall within the activities permitted under G.S. 93A-2(c)(6), then the acts being performed there do *not* require a license, as they fall within the property management exception. Thus, those locations would not be "offices" as defined in Rule A.0110(b) and would not require a separate broker-in-charge. The employing broker/broker-in-charge would be responsible for supervising all of his/her/its unlicensed salaried employees at their various locations.

RECEIVING AND DEPOSITING RENTS AND TENANT SECURITY DEPOSITS

General Rules

Licenseses should remember the following basic points regarding the receipt and deposit of rents and tenant security deposits received from properties owned by others which they are managing for a fee.

- *Rents and tenant security deposits are “trust monies” that must be deposited in a broker’s/firm’s trust account. If received by an individual licensee affiliated with a broker or firm, the trust money received must be immediately delivered to the **broker-in-charge** or the person designated by the broker-in-charge to handle such funds.*
- *The broker-in-charge is responsible for the proper maintenance of the trust account. While a broker-in-charge may delegate to another licensee or to an unlicensed person (for example, a bookkeeper) the administrative responsibilities for handling trust funds and maintaining trust account records, the broker-in-charge remains fully responsible under Commission rules for the proper handling of trust funds and maintenance of the trust account and should inspect such records monthly.*
- *A North Carolina broker managing property located in North Carolina must open and maintain a brokerage trust account with a licensed and insured bank or savings institution located in the State of North Carolina.*
- Rents and tenant security deposits, as well as earnest money deposits on sales transactions or any other trust monies received by a broker, may all be deposited and maintained in a single trust account. There is no requirement that separate trust accounts be maintained for rental and sales transactions, although many brokers/firms, especially those with substantial sales and rental transactions, elect to maintain separate accounts.
- **Rents:** *Rents must be deposited in the broker’s trust account not later than three (3) banking days following receipt of the funds by the broker or any of his/her agents or employees, regardless of the method of payment.*

NOTE: FDIC Trust Account Insurance Limits Increased. So long as all trust accounts are properly identified as either a “trust account” or “escrow account,” then all funds contained in the account will be fully insured by the FDIC or FSLIC so long as no one depositor’s interest exceeds \$250,000. In other words, if a real estate company manages 300 rental properties and is holding over \$300,000 in its tenant security deposit trust account, all \$300,000 is insured, so long as no individual tenant’s security deposit exceeds \$250,000 (unlikely). While the FDIC insurance limit used to be \$100,000, it has been raised to \$250,000 per depositor.

Residential Tenant Security Deposits

The Tenant Security Deposit Act

Years ago the General Assembly enacted legislation regarding *residential landlord-tenant relationships*. These laws, found in Chapter 42 of the North Carolina General Statutes, impose certain obligations on both residential landlords and tenants and afford each certain rights. There are no corollary statutes regulating the rights or obligations of landlords or tenants in commercial lease situations. Commercial tenants' and landlords' rights and obligations typically are defined by the terms of the lease agreement. Thus, *the following discussion is limited to residential leasing*, which is governed by statute.

G.S. 42-50: Deposits from the tenant.

Security deposits from the tenant in residential dwelling units shall be deposited in a trust account with a licensed and insured bank or savings institution located in the State of North Carolina or the landlord may, at his option, furnish a bond from an insurance company licensed to do business in North Carolina. The security deposits from the tenant may be held in a trust account outside of the State of North Carolina only if the landlord provides the tenant with an adequate bond in the amount of said deposits. The landlord or his agent shall notify the tenant within 30 days after the beginning of the lease term of the name and address of the bank or institution where his deposit is currently located or the name of the insurance company providing the bond.

Comment: Note that *this law applies to real estate licensees and individual property owners who hold residential tenant security deposits*. Key requirements include:

- Deposit of tenant security deposits in a *trust or escrow account*
- Account must be with a licensed and *insured bank or savings and loan in North Carolina*

Although the Tenant Security Deposit Act permits a landlord to keep the tenant security deposit and simply supply the tenant with a bond, *real estate licensees must always retain the deposit in a trust account when acting as an agent (see below discussion)*. Thus, the option of furnishing a bond is not available to broker-property managers leasing property owned by others.

Real Estate License Law and Commission Rules

- If paid by **cash**, a tenant security deposit received by a broker must be deposited in the broker's trust account *not later than three (3) banking days following receipt of the security deposit, regardless of whether a lease agreement has been signed*.
- If paid by **check** (or some other negotiable instrument, such as a money order), *a tenant security deposit may be held by the broker until the lease is signed by both the tenant and the landlord* (or the broker or representative of the broker acting as

the landlord's agent, if granted that authority in the property management agreement). *The check for the tenant security deposit must be deposited in the trust account not later than **three (3) banking days following acceptance** (signing by both parties) **of the lease**.* Note that the broker is not *required* to hold the tenant security deposit check until lease formation and may deposit the check immediately if that approach is preferred.

However, situations do arise where a prospective renter's application is not accepted and there is a need to refund the tenant security deposit to the prospective renter. If the check was deposited, the broker will have to wait for bank verification that the check has cleared before refunding the deposit. Whereas, if the check was held until a valid lease was formed, then the broker could instead merely return the check to the prospective renter when no lease agreement is reached. To avoid having an unnecessary delay in refunding deposits and creating a problem for the prospective tenant who may need the money to seek a rental unit elsewhere, not to mention the additional bookkeeping required when a check is deposited, many brokers choose the option of holding the check until final action is taken on the lease. *A broker who holds checks for tenant security deposits pending final action on a proposed lease is responsible for safeguarding the check and should have office policies specifying how that is accomplished.*

Tenant Security Deposit Limits

Brokers should also remember that the Tenant Security Deposit Act *limits the maximum amount that a **residential** landlord can collect as a security deposit.* [See G.S. 42-51.]

Security Deposit Limits

- Week-to-week tenancy: *Two weeks' rent maximum*
- Month-to-month tenancy: *One & one-half months' rent maximum*
- Terms greater than month-to-month: *Two months' rent maximum*

Example: A landlord leases an apartment for a one-year term at \$600/month rent. The landlord can require a security deposit of up to \$1200. (If the tenancy had been month-to-month at the same rental, the maximum security deposit allowed by law would have been \$900.)

Pet Deposits

The Tenant Security Deposit Act **does** permit the landlord to require a separate "... *reasonable, nonrefundable fee* for pets kept by the tenant on the premises." The statute does not attempt to define what is "reasonable." [See G.S. 42-53.]

Queries:

1. *If the deposit is nonrefundable, may it be paid immediately to the property owner?*
So long as the lease doesn't prohibit it.
2. *May an owner charge a pet deposit for a service animal?*

No. Service animals are not considered “pets.” Under the Americans with Disabilities Act, a service animal is *any* guide dog, signal dog, or other animal individually trained to provide assistance to a human with a disability.

3. *If the service animal causes damage to the unit, may actual repair expenses be deducted from the tenant security deposit?*

Yes.

IMPORTANT NOTE: The Tenant Security Deposit Act expressly states that its provisions “... shall apply to all persons, firms, or corporations engaged in the business of renting or managing **residential** dwelling units, excluding single rooms, on a weekly, monthly or annual basis.” [See G.S.42-56.] *Thus, ALL residential landlords and real estate agents who manage residential rental property for others or for themselves are specifically subject to the requirements of this Act.*

TRUST MONIES ON BROKER-OWNED PROPERTIES

As just noted, the North Carolina Tenant Security Deposit Act requires all residential landlords to keep a tenant’s security deposit in a trust account or to post a bond. *If a broker who owns residential rental property is handling the rental of the property as an owner in a manner that is completely independent of his/her real estate brokerage business and is not using the services of any broker/firm in connection with the rentals, then the broker-property owner is acting solely as a residential landlord. Accordingly, the rents go into his/her personal checking account and s/he may elect to post a bond for the tenant security deposits rather than setting up a trust account for that purpose. **This section does NOT address these situations.***

*If, however, a broker who owns residential rental property wants to manage his own rentals through his/her real estate brokerage business or use the services of a broker/firm in connection with the rentals, then the broker must be extremely careful to avoid violating the License Law provision that prohibits “...**commingling** the money or other property of his or her principals with his or her own...” [G.S. 93A-6(a)(12).] **This section focuses on these situations.***

Brokers who sell or lease their own properties must not commingle funds received in connection with their own properties with funds they hold in trust for others. Earnest money, residential tenant security deposits, and other funds required to be held in trust in a transaction involving broker-owned property must be held in a separate trust account from the broker’s brokerage trust account.

For example, if a broker does business as a sole proprietorship, and also owns several rental houses, the broker may not deposit either the rents or the tenant security deposits for the broker-owned rental properties into his/her sole proprietorship trust account since it contains monies belonging to others. To do so would constitute commingling, as the rents belong to and are income to the broker who also has a potential interest in the tenant security deposits for

properties s/he owns if the tenants cause damage or default on their lease obligations. Thus, the broker should deposit tenant security deposits from his/her own residential tenants into a trust account *other than* his/her brokerage trust account. The rent proceeds may be deposited directly into the broker's personal checking or savings account and would *not* be run through any trust account (assuming the broker is wearing his/her property owner hat, rather than his/her licensee hat).

*Only when the owner of the rental property and the owner of the real estate company (and hence the trust account) have **separate legal identities** may the broker deposit trust monies from his/her rental property into a real estate brokerage trust account. **Basically, the only time this can be accomplished is where either the real estate company or the property owner is a corporation.*** For example, if the broker's real estate company is a **corporation**, and the property is owned by the broker individually, then the corporation may manage the individual broker's property and may deposit both rental receipts and tenant security deposits into the corporation's brokerage trust account(s), *if* the corporation has a written property management agreement with the broker-owner. While this really is the lone exception, the following examples are provided for illustration.

EXAMPLE 1: Property Owner = Your Realty Co., Inc.
Brokerage Company = Your Realty Co., Inc.

DO NOT DEPOSIT rents, tenant security deposits and earnest money deposits collected on property owned by Your Realty Company, Inc. into Your Realty Company, Inc.'s trust account which contains third party trust funds. In this case, there is no separateness as the owner of the property and the owner/holder of the trust account are the same entity. Thus, tenant security deposits and earnest money deposits collected on property owned by Your Realty Company, Inc. should be held in a **separate** trust account from the brokerage trust account to avoid clear commingling. Rents collected on property owned by Your Realty Company, Inc. are not trust funds and should be deposited directly into the company's business operating account.

EXAMPLE 2: Property Owner = John Broker, Shareholder (can be Officer/Employee)
Brokerage Company = Your Realty Company, Inc.

PERMISSIBLE TO DEPOSIT rents, tenant security deposits and earnest money deposits collected on property owned by John Broker into Your Realty Company, Inc.'s brokerage trust account which contains third party trust funds. John Broker is a separate legal being (i.e., an individual) from Your Realty Company, Inc. (a corporation) and Your Realty Company, Inc. has no ownership interest in the property. Your Realty Company, Inc. can manage the individual broker's property and deposit trust funds collected on this property into the corporation's trust account, *so long as* there is an underlying listing or property management agreement between the shareholder/officer-broker/property owner and the corporate real estate company.

EXAMPLE 3: Property Owner = John Broker, Member
Brokerage Company = Your Realty Company, LLC

DO NOT DEPOSIT rents, tenant security deposits and earnest money deposits collected on property owned by John Broker into Your Realty Company, LLC's trust account which contains third party trust funds. A limited liability company has **not** been clearly determined to afford the same legal separation between the entity and its member-owners as a corporation has from its shareholders. Earnest money deposits, tenant security deposits or rent collected on property owned by John Broker should be held in a **separate** trust account. (**Note:** the Company still would need a written agency agreement with John before it could list or lease his property.)

EXAMPLE 4: Property Owner = John Broker
Brokerage Company = John Broker Real Estate, Sole Proprietor

DO NOT DEPOSIT rents, tenant security deposits and earnest money deposits collected on property owned by John Broker into John Broker Real Estate's brokerage trust account which contains third party client trust funds. Tenant security deposits and earnest money deposits collected on property owned by John Broker should be held in a **separate** trust account. Rents collected on property owned by John Broker are not trust funds and should be deposited into the company's business operating account or John Broker's personal bank account.

EXAMPLE 5: Property Owner = John Smith, Partner
Brokerage Company = Smith/Jones Partnership

DO NOT DEPOSIT rents, tenant security deposits and earnest money deposits collected on property owned by John Smith into the Smith/Jones Partnership trust account which contains third party client trust funds. A partnership does **not** afford the same legal separation from the partners as a corporation does from its shareholders. Earnest money deposits, tenant security deposits and rent collected on property owned by John Smith should be held in a **separate** trust account from the brokerage trust account and the partnership must have a written agency agreement to act as John's agent in selling or leasing his property.

CAUTION: *A broker who is uncertain whether money from personally-owned rental properties may be deposited into his/her brokerage trust account should deposit such funds in a separate trust account in order to assure compliance and avoid commingling.*

DISBURSING RENTAL MONIES AND TENANT SECURITY DEPOSITS

As previously discussed, **brokers handling the rental of properties for others must deposit all rental income and tenant security deposits into his or her brokerage trust account.** Real Estate Commission rules and Trust Account Guidelines require that *all disbursements of trust monies required in connection with a property being rented by a broker must be made directly from the broker's trust account to the person(s) entitled to such funds.*

This section will discuss permitted and prohibited disbursements of rental income and tenant security deposits.

Disbursements of Rental Income

The scope and extent of a broker's authority to expend funds from rental income on behalf of the property owner should be expressly stated in a Property Management Agreement, and it must be in writing from the beginning of the relationship.

- **In General:** *Disbursements of rental income may be used to pay the operating expenses of the leased property (utilities, maintenance, mortgage payments, administrative costs, broker's fees, etc.), if authorized in the management agreement, with the balance remitted to the property owner.*
- **Operating Expenses:** Although a broker-property manager must pay the operating expenses for a leased property in a timely manner, *disbursements made in connection with the rental of a property must never exceed the amount of rental funds held for that property's owner.* To spend more than an owner has in the account (*excluding* the tenant security deposit, which can't be used until the end of the tenancy) results in **"deficit spending" which is not permitted.**

EXAMPLE: If a broker-property manager has collected only \$600 in rent for a property owned by Mr. A, s/he cannot disburse \$800 from his trust account to repair Mr. A's roof. Although the total of all funds in the broker's trust account may be sufficient to cover the \$800 expenditure, such payment would, of course, result in the disbursement of funds belonging to other persons (i.e., \$200) to help pay for Mr. A's roof.

Suppose, however, that the broker managed three properties for Mr. A and the total rents being held for Mr. A in the broker's trust account was \$1,800. In that case, the broker could pay the \$800 needed to repair the roof of one of the three properties.

The Property Management Agreement should specify the procedure to follow in situations where expenses exceed receipts for a particular owner. For example, the agreement may authorize the broker to hold a certain sum of money in reserve, or the broker-property manager may agree to pay such expenses from his or her general operating account and then be reimbursed as rents are collected. The property manager should not, however, place any of his or her own funds into the trust account to offset such "deficit spending," because this would, of course, constitute a commingling of the property manager's funds with funds s/he is holding for others. Instead, the broker would write two checks to the roofer – one for \$600 from the trust account and a second check for \$200 from the broker's operating account, which advance or loan would be entered on the property ledger sheet.

Brokers also should be cautious about promising to pay net rent proceeds to owners by a specified date in their property management agreements, as even though the rent may be due by the 1st and late after the 5th, it still does not assure that tenants will timely pay the rent. Thus, if the property management agreement states that the broker will forward net rent proceeds to the owner by the 10th of each month, yet the broker does not receive the rent from the tenant until the 11th day in a particular month, the broker exposes him/herself to a possible breach of the terms of his/her agency agreement. Obviously, a broker can not pay what s/he has not received and to issue a rent proceeds check to the property owner prior to receipt of the rent would constitute deficit spending. Even if the tenant had paid the rent by check on the 8th day of the month, the broker still should not issue a check until s/he is confident that the tenant's check has in fact been honored.

Property Management Fees: *Property management fees (as well as any interest earned by the broker on an interest-bearing trust account), should be disbursed promptly (within 30 days) from the trust account to the broker's general operating account, and division of earned fees among the broker's agents or employees should be paid from the general business account.*

Disbursements of Residential Tenant Security Deposits

Permitted Uses of Security Deposits

Permitted uses of security deposits for residential dwelling units by a landlord or agent of the landlord are limited to those set forth at **General Statute §42-51**. *The only permitted uses or deductions are:*

1. nonpayment of rent (unpaid rent that is due);
2. cost of water and sewer services provided by the lessor per G.S. 62-110(g);
3. damage to the premises (other than damage due to "ordinary wear and tear");
4. nonfulfillment of rental period (future rent due under the lease when the landlord is unable to re-rent the unit for a similar amount after diligent efforts to do so);
5. unpaid bills from the tenant's occupancy which become a lien against the property;
6. the cost of re-renting the premises after a breach of the lease by the tenant;
7. costs of removal and storage of tenant's property; or
8. court costs in connection with terminating a tenancy.

No deductions for any other purpose is allowed under North Carolina law. Automatic forfeiture or termination fees may not be included in *residential* lease agreements.

Where Property Is Re-rented

One common misunderstanding among landlords and property managers is their apparent belief that the landlord automatically may keep the entire security deposit when a tenant breaches the lease and abandons the rented unit prior to expiration of the lease period. This is not the case. When this situation occurs, the landlord (or his agent) is obligated to diligently attempt to obtain

another tenant for the unit. If the landlord is unsuccessful in obtaining another tenant, he may keep that portion of the security deposit which equals the rent he would have received if the tenant had not breached the lease. Frequently, the amount of rent that would have been earned under the lease (i.e., the “lost rent”) exceeds the amount of the security deposit. In that case, the landlord may keep the entire security deposit. If, however, the landlord is successful in finding a new tenant, the landlord can only retain that portion of the security deposit which is equal to the “lost rent” plus the amount of the landlord's actual cost in re-renting the unit.

EXAMPLE: Tammy Tenant rented an apartment for six months at \$600 per month and gave the landlord a \$600 security deposit. Tammy breaches the lease, which expires on June 30, and leaves the apartment on May 31. The landlord is able to promptly obtain a new tenant at \$600 per month, who moves in on June 16. The landlord's costs in obtaining the new tenant were \$50. The landlord may retain \$300 (15 days of rent) plus \$50, for a total of \$350, from the security deposit. The remaining \$250 balance of the tenant security deposit must be refunded to Tammy, unless the landlord is entitled to retain an additional amount for another legitimate reason, such as damage to the apartment that was not due to ordinary wear and tear.

Where Property Is Damaged

The landlord may use the tenant's security deposit to pay the cost of repairing damage to the rented unit at the end of the tenancy. *A landlord may **not**, however, keep any part of the security deposit to repair conditions arising from “ordinary wear and tear” of the premises, **nor can the landlord keep any amount from the deposit which exceeds the landlord's actual damages.***

EXAMPLE: At the end of Tabitha Tenant's five years of occupancy of Apartment 343, her landlord retained Tabitha's \$600 security deposit because the apartment needed new carpeting. The carpeting in the apartment was 10 years old and had simply worn out from ordinary use. There was no unusual or special damage to the carpet caused by Tabitha. The landlord has violated the Tenant Security Deposit Act for retaining the \$600 security deposit. Tabitha has a claim for damages against the landlord for the return of her security deposit.

EXAMPLE: Bret Broker, a licensed real estate broker and manager of the Megaunits apartment complex in Raleigh, routinely keeps 30% of each security deposit after a tenant has ended the tenancy as a “cleaning fee.” This fee is charged for ordinary cleaning of each departing tenant's unit. Bret has violated the Tenant Security Deposit Act and can be sued for damages. Bret also has violated his duties as a licensed real estate broker.

Disputes between landlords (or their rental agents) and tenants over what constitutes “*damage due to ordinary wear and tear*” versus “*other damage*” in residential rental situations are very commonplace. Such disputes most frequently arise from a lack of clear understanding by one or both parties as to the meaning of these terms. There are no North Carolina statutes or court

decisions defining “ordinary wear and tear,” probably because such determinations must necessarily be made on a case-by-case basis. However, both the North Carolina Department of Justice and North Carolina Real Estate Commission have published consumer information pamphlets on the Tenant Security Deposit Act, and these publications provide excellent guidance for landlords, property managers and tenants on this subject. Based primarily on the information in these publications, the following lists of common examples of “damage due to ordinary wear and tear” and “other damage” are provided:

Common Examples of “Damage Due to Ordinary Wear and Tear”

- Worn or dirty carpeting
- Faded or cracked paint
- Dirty windows
- Dirty walls
- Frayed or broken curtain or blind strings
- Leaking faucets or toilets
- Small nail holes in walls (from hanging pictures)
- Worn lavatory basin
- Burned-out range heating elements

*Landlords and property managers may **not** use a tenant security deposit to cover the expense of correcting problems resulting from “ordinary wear and tear.”* These expenses are considered to be part of the landlord's cost of doing business.

Common Examples of “Other Damage”

- Crayon marks on walls
- Large holes in walls
- Broken windows
- Burned spots or stains on carpeting
- Bizarre or unauthorized paint colors
- Broken counter tops
- Filthy appliances (such as ovens or refrigerators) requiring extraordinary cleaning
- Exceptionally filthy premises (in general) requiring extraordinary cleaning

*Deductions may be made from a tenant security deposit to cover the expense of repairing “damage **not** due to ordinary wear and tear” which occurred during the tenancy.* May an owner/property manager specify preset amounts for various repairs in the lease agreement? Such a practice would not be favored and is discouraged, because the statute prohibits a property owner from deducting more than his/her *actual repair expenses*. One can not reasonably foresee in advance what repairs may be necessary and why and what the repair cost will be.

Many of the disputes that arise in this area can be avoided if the property manager or rental agent would make proper use of property condition checklists. It would also help if rental agents would explain to new tenants at the time the lease is signed what is expected of tenants with regard to maintaining the property.

Accounting to the Tenant

The law dictating the time frame within which tenant security deposits must be returned in long-term tenancies (G.S. 42-52) changed as of October 1, 2009. Because of this recent revision, the new statute is reprinted below with the new language underlined.

G.S. 42-52, Landlord's obligations.

Upon termination of the tenancy, money held by the landlord as security may be applied as permitted in G.S. 42-51 or, if not so applied, shall be refunded to the tenant. In either case the landlord in writing shall itemize any damage and mail or deliver same to the tenant, together with the balance of the security deposit, no later than 30 days after termination of the tenancy and delivery of possession of the premises to the landlord. If the extent of the landlord's claim against the security deposit cannot be determined within 30 days, the landlord shall provide the tenant with an interim accounting no later than 30 days after termination of the tenancy and delivery of possession of the premises to the landlord and shall provide a final accounting within 60 days after termination of the tenancy and delivery of possession of the premises to the landlord. If the tenant's address is unknown the landlord shall apply the deposit as permitted in G.S. 42-51 after a period of 30 days and the landlord shall hold the balance of the deposit for collection by the tenant for at least six months. The landlord may not withhold as damages part of the security deposit for conditions that are due to normal wear and tear nor may the landlord retain an amount from the security deposit which exceeds his actual damages. (Effective Oct 1, 2009.)

By law, the landlord (*or his or her broker/property manager*) *must account to the tenant in writing for the security deposit initially within 30 days of termination of the tenancy.* (Within 45 days of the termination of the tenancy in vacation rentals.) The landlord/broker must refund the security deposit, or the portion to which the tenant is entitled, and must account to the tenant for any portion of the security deposit that is not refunded, ***itemizing the amount and purpose of each deduction.*** If the tenant security deposit is not wholly consumed by permissible charges, such as unpaid rent, or unpaid water and sewer, or damages, within 30 days of the termination of the tenancy, but the landlord anticipates additional damage claims, then under the revised law, the landlord would provide an initial written accounting of all known charges to the tenant within 30 days and would indicate that additional deductions were anticipated and that a final accounting would be provided no later than 60 days from the termination of the tenancy. All monies due the tenant must be refunded to the tenant within 30 days of the termination of the tenancy unless there are still possible additional deductions to be determined, in which event any refund must occur no later than 60 days following the termination of the tenancy.

If the tenant's new address is unknown to the landlord, then the landlord/broker may deduct permissible expenses from the security deposit "... *after* a period of 30 days..." and must retain the balance, if any, in the landlord's (or broker's) trust account for collection by the tenant "... for at least six months..." Note that the written accounting and any refund may be sent by regular first class mail; certified mail is not required.

The only time a broker should ever have a residential tenant security deposit in his/her trust account more than thirty days (or sixty days in permitted situations) after the termination of the tenancy is if the broker can not locate the tenant after reasonable efforts to find him/her.

Landlords or their agents *must hold the tenant security deposit in their trust account for at least six months after the termination of the tenancy* and refund that portion owed to the tenant if contacted by the tenant. Unfortunately, the statute (G.S. 42-52) is silent concerning what happens to the tenant security deposit if the landlord/broker can not find the tenant.

What to do with a tenant security deposit which is owed a former tenant who can not be located? Licensees must diligently attempt to locate the tenant and, if unsuccessful, should retain the tenant's security deposit in the trust or escrow account until the tenant either resurfaces or a period of time elapses with no contact, after which the deposit may escheat to the State. Understand that *a tenant security deposit does not automatically become the landlord's property merely because it is unclaimed*. It still belongs by law to the tenant and the only permitted deductions or uses of residential tenant security deposits are those set forth in G.S. 42-51 (and default payment to the landlord is *not* one of them).

Escheat of Unclaimed Property

One option available to a broker or landlord could be to escheat the balance of the security deposit to the State Treasurer. "Escheat" is the recovery of unclaimed property. "Unclaimed property" arises when the person legally entitled to the property fails to make a valid claim to or communicate with the holder of the property to evidence an interest in the property for a certain period of time, known as the "dormancy period." Dormancy periods vary, depending on the type of property at issue, and are listed on the back of reporting form ASD-159. A "holder" is defined as "... a person obligated to hold for the account of or deliver or pay to owner property that is subject to ..." Chapter 116B of the North Carolina General Statutes. "***Security deposits***" are ***expressly included in the definition of property*** under G.S. 116B-52(11b). The dormancy period for holding security deposits prior to escheat is five years, as is the dormancy period for refunds. *However, that is the maximum period during which the monies must be held*. Thus, a licensee (or landlord) who has held a tenant security deposit due a former tenant for two years with no contact from the former tenant, may complete the necessary paperwork and escheat the deposit to the State Treasurer after only two years, rather than waiting the full five years. The report must be filed with the State Treasurer no later than November 1 of any given year.

Before a holder may send unclaimed funds to the State Treasurer, the holder (i.e., broker or landlord) "... shall make a good faith effort to locate an apparent owner" Where the value of the property is fifty dollars (\$50.00) or more, the holder shall send a *written notice by first-class mail to the last known address of the owner describing the property held, the name and address of the holder, and informing the owner that a claim must be presented by the following October 1 or the property/monies will be placed in the custody of the North Carolina State Treasurer*, to whom all further claims should be directed. This notice must be mailed not more than 120 days nor less than 60 days prior to the holder filing the requisite report and transferring the property to the State Treasurer. Holders who fail to mail the required notice may be subject to a penalty under G.S. 116B-77. Reports of Unclaimed Property should be filed with the State Treasurer using Forms ASD-159 and ASD-21, both of which, as well as a sample Notice to Owner, may be found at the State Treasurer's website at www.treasurer.state.nc.us. The website also has "Frequently Asked Questions" as well as the "Unclaimed Property Manual" which basically is a reprint of Chapter 116B of the North Carolina General Statutes.

RECENT LEGISLATION PROTECTING TENANTS IN FORECLOSURE SITUATIONS

Lastly, brokers involved with residential rentals should be aware of two recently enacted laws, one a North Carolina statute and one a federal statute, that provide some protection to residential tenants when the rented property is involved in a foreclosure situation.

Notice to Tenants of Pending Foreclosure Sale

Amendments to **North Carolina** foreclosure statutes [G.S. 45-21.16A(b) and 45-21.17(4)] that were *effective October 1, 2007* require a mortgagee (or loan servicer acting for the mortgagee) or trustee (acting for the beneficiary under a deed of trust) who is foreclosing on *residential rental property with less than 15 units* to send by first class mail a *notice of the foreclosure sale to all tenants at least 20 days prior to the sale date*. [If the name of a tenant is not known, the notice must be sent to “occupant” at the address of the property to be sold.] The notice must advise the tenants of the following:

- Details about the foreclosure sale.
- A statement explaining that, following the foreclosure sale, an order for possession of the property may be issued in favor of the purchaser and against the party(ies) in possession by the clerk of superior court of the county where the property is located. [Essentially, this is an order authorizing the sheriff to remove all occupants and their personal property from the premises and to put the purchaser in possession. The tenant/occupant must have been given 10 days notice prior to the date application for the order of possession is made, BUT see the federal law discussed in the next subsection that, *until December 31, 2012*, overrides this notice provision and effectively extends the tenant’s right to remain in possession in some situations.]
- A statement explaining that a tenant who entered into or renewed his/her lease on or after October 1, 2007 may, after receiving the notice of sale, terminate his/her lease upon 10 days written notice to the landlord, and also stating that any tenant terminating in this manner is liable for prorated rent to the effective date of termination.

Protecting Tenants at Foreclosure Act of 2009

A **federal** law *effective May 20, 2009* greatly expands the rights of residential tenants and overrides state laws as to the rights of purchasers of residential rental properties at foreclosure to have existing tenants evicted and gain possession of the property with only a short notice period. The law requires that a purchaser at foreclosure of any residential real property with existing “bona fide” tenants must provide those existing tenants, including tenants receiving Section 8 rental assistance, with *at least 90 days notice to vacate the property* before seeking an order for possession.

A **bona fide tenant** does *not* include the mortgagor, or child, spouse or parent of the mortgagor who is living in the property. These four categories are expressly excluded by statute. A *bona fide tenant* is any other person who entered into the lease or tenancy as the result of an arm's length transaction and who pays an amount of rent not substantially less than the fair market rent.

Tenants under Existing Leases.

This law permits (with one exception noted below) *all tenants of residential real property under a lease entered into before issuance of a notice of foreclosure on the leased property to continue to occupy the leased premises until the end of the lease term*. Thus, if a residential tenant signs a one-year lease on October 1, 2009, a notice of foreclosure is issued on December 1, 2009 and the foreclosure sale is completed on February 1, 2010, the purchaser at the foreclosure sale must honor the tenant's lease until it expires on September 30, 2010.

There is one **exception** to a tenant's right to keep possession under a pre-existing lease. *If the purchaser at foreclosure will occupy the leased premises as a primary residence, then the tenant's lease (tenancy) may be terminated with 90 days notice to the tenant.*

Tenants at Will or With No Lease.

A tenant in possession of a foreclosed residential property with no lease or a lease that is terminable at will must be provided *90 days notice* prior to a purchaser at foreclosure being able to evict the tenant and gain possession of the property.

Sunset Provision. *This law will "sunset" (i.e., automatically be repealed) on December 31, 2012.* This means the law is "temporary" unless Congress extends it prior to the sunset date.

Comments. This "temporary" federal law creates a major change in the rights of both purchasers and tenants of foreclosed residential property. Prior to the enactment of this law, the law in North Carolina and most other states provided that a tenant's rights are terminated by foreclosure and that the purchaser at foreclosure could gain possession by obtaining an "order for possession" (essentially an eviction order) with only a short notice required (10 days for most residential properties). This federal law provides tenants with much expanded rights to continue in possession after foreclosure.

It might seem, as a practical matter that a purchaser of residential rental property would want to retain tenants, not evict them, even if the purchaser intends to sell the property, as empty buildings are more prone to vandalism and maintenance/deterioration issues may not be detected as quickly. Additionally, investment properties with stable rent-paying tenants presumably would increase the value (or at least the allure) of the property. Nonetheless, Congress learned that all across the country thousands of families were being summarily evicted from their rental properties with virtually no notice, even though they were current in their rent payments and had not breached the terms of their lease. Their only "fault" was living in a property on which the owner had defaulted on the mortgage payments, unbeknownst to the tenants. Hence, the new legislation to provide some protection for tenants living in foreclosed properties.