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## Legal Alert

### **Think Twice Before Serving A Three-Day Notice to Pay Rent or Quit**

With tenant defaults on the rise, it is natural for landlords and property managers to resort to service of a three-day "Notice to Pay Rent or Quit." In fact, landlords and managers should think twice before serving a three-day Notice to Pay Rent or Quit.

While landlords and property managers often use the service of a three-day Notice to Pay Rent or Quit as a collection device to prompt a delinquent tenant to pay its past due rent, such a notice should not be served without first considering the legal consequences associated with taking such action and whether those consequences are desired. Legal counsel should be sought to determine the best tactical approach to achieve the landlord's primary goals. As explained below, if regaining possession of the leased premises is the landlord's primary objective, then the prompt service of a three-day notice is most likely advisable. If, however, the tenant is solvent, and collection of the rent is the primary objective, then a three-day notice may not be the preferred approach.

### **What are the consequences of serving a three-day Notice to Pay Rent or Quit?**

1. Service of the three-day Notice to Pay Rent or Quit can limit the landlord's rights. Under California law, if the lease so provides, and if the lease permits the tenant to assign or sublet, a landlord has the right to keep a lease in effect if the tenant fails to pay rent, regardless of whether the tenant also abandons the premises. (Civil Code section 1951.4.) If the landlord invokes this right, the tenant retains the legal right to possession, the landlord has no duty to mitigate damages, and the landlord can sue the tenant for all rent due up to the time of trial.

This strategy may be particularly useful if a tenant is solvent and the landlord desires to place the burden of mitigation (by assignment or subletting) on the tenant. This option can be particularly beneficial in the current economic climate if the tenant is an otherwise creditworthy company that has simply elected to close an office, retail or warehouse location that is not part of its current business plan.

By contrast, if the landlord terminates the tenant's right to possession by service of a three-day Notice to Pay Rent or Quit, the duty to mitigate shifts to the landlord. In any



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subsequent lawsuit against the tenant for damages, the reasonableness of the landlord's efforts to mitigate its damages, and hence the amount of the judgment it may obtain, will be hotly contested. If the lawsuit is filed before the premises have been re-leased, discovery concerning ongoing negotiations can be intrusive. The landlord can avoid the duty to mitigate, and related litigation, by invoking its right to keep the lease in effect. Shifting the burden of mitigation to the tenant can also be beneficial where the landlord does not have the desire, ability or resources to manage the property and to undertake the search for a replacement tenant.

If the landlord initially chooses to keep the lease in effect, and later desires to recover possession of the premises, either because the landlord has obtained a replacement tenant or for some other reason, the landlord can at that time (provided the rent remains unpaid for at least 14 days) serve a Notice of Belief of Abandonment. If the tenant does not claim possession of the premises within a 15 to 18-day period (depending upon the method of service) following service of the Notice of Belief of Abandonment, the landlord is thereupon restored to possession. The landlord can then amend its complaint to add a claim for the present value of the future lost rent (which is subject to mitigation). If the tenant does claim possession within the 15 to 18 day period following service of the Notice of Belief of Abandonment, then the landlord can recover possession of the premises by serving a three-day Notice to Pay Rent or Quit at that time, followed by an unlawful detainer action. A landlord may concurrently serve a three-day Notice to Pay Rent or Quit and a Notice of Belief of Abandonment.

The remedy of keeping the lease in effect, however, may be irrevocably lost if a Notice to Pay Rent or Quit is served, especially if the tenant, after receiving such notice, relinquishes possession of the premises. Although there is authority that the notice may be withdrawn *within* the three-day period, there is no authority that the notice may be withdrawn *after* expiration of the three-day period. Thus, once the three-day period expires, the tenant's right to possession has been terminated under state law.

Moreover, if the tenant "quits" the premises – one of the two alternatives given to the tenant in the notice – the lease terminates. (Civil Code § 1951.2.) This shifts the burden of mitigation to the Landlord.

Furthermore, unless the landlord has a "state of the art" security deposit clause, including an appropriate waiver of section 1950.7 of the Civil Code, termination of the lease may limit the landlord's ability to retain the entire security deposit or proceeds of a letter of credit.

Thus, service of a Notice to Pay Rent or Quit can have the effect of precluding the landlord from keeping the lease in effect and suing for rent as it becomes due and instead requiring the landlord to take possession and

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mitigate its damages. Of course, this effect can be undone by subsequent agreement between landlord and tenant, such as in a workout or modification.

2. Nonetheless, service of a three-day Notice to Pay Rent or Quit is a precondition for asserting some rights, including commencement of an unlawful detainer action to recover possession where the tenant remains in possession despite non-payment of rent, and the landlord desires to recover possession of the property.
3. Service of a three-day Notice to Pay Rent or Quit also has implications if the tenant files for bankruptcy protection. Bankruptcy courts look to state law to determine whether the debtor-tenant has an interest in the leased real property. In the Ninth Circuit (governing California and neighboring states), the prevailing view is that a lease is considered terminated for nonpayment of rent by at least the time the landlord files an unlawful detainer action after a proper Notice to Pay Rent or Quit has been served. Once the lease has been terminated, there is no longer a leasehold interest that can be assumed and assigned under the Bankruptcy Code. Similarly, the pre-bankruptcy termination of the lease may provide grounds for relief from the automatic stay, allowing the landlord to continue with eviction proceedings notwithstanding the tenant's bankruptcy.

In light of the significant legal effects of serving a three-day Notice to Pay Rent or Quit, landlords and property managers should consider those effects before serving such a Notice, and should seek legal counsel as appropriate.

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