

Chapter 1

Grasping the Legal Fundamentals of Managing Residential Rentals

In This Chapter

- ▶ Incorporating for legal protection and income optimization
 - ▶ Stepping into a rental property as its new owner
 - ▶ Getting up to speed on landlord legalities
-

Whenever you approach a subject for the first time, you probably try to wrap your brain around it before getting into the specifics. This chapter helps you gain the big-picture perspective by highlighting the key legal aspects of being a landlord and managing residential rentals. Think of this chapter as a framework on which you can hang all the detailed information, guidance, and insights we present throughout this book.

This chapter begins by laying out the legal foundation for your residential rental operation. The first section stresses the importance of running your business as a legal entity in order to protect your personal assets, minimize taxes, and maximize profits. The second section touches on important steps to follow when taking ownership of the property. The third and longest section in this chapter introduces your legal obligations as a landlord; here you find out how to fulfill your obligations while protecting your rights and avoiding legal problems.

Running Your Operation as a Corporation or LLC

Unless you take steps to give your business the status of a corporation or limited liability company (LLC), you're operating as a sole proprietorship and placing your personal assets at risk. If you can't pay what you owe to a creditor, such as a contractor, a utility company, or the bank that holds the mortgage on

your property, they can pursue your personal assets to collect what you owe. Operating your business as a corporation or LLC insulates your personal assets from your business assets, thus protecting your personal assets from such claims. In addition, operating your business as a corporation or LLC potentially reduces your taxes, increasing your net profit.

Most landlords choose to operate as an LLC, because it provides the protection of a corporation without the costs and complexities of forming and managing a corporation. Any claims by creditors against the LLC are limited to the LLC's assets, protecting your home, personal financial accounts, and other personal assets from those claims.



An LLC doesn't provide complete protection. If a court finds that your carelessness or negligence contributed to a resident's injury, for example, you could be held personally liable. We recommend that you purchase a landlord insurance policy that covers such scenarios, as explained in Chapter 3.

Structuring your business and operating it as a corporation is much more complicated and expensive than forming an LLC. You need to register a name for your corporation with your state's Secretary of State, write and file articles of incorporation and bylaws, issue stock (at least one share), have regular corporate meetings, prepare and file minutes from those meetings, and comply with regulations for recording and reporting financial transactions. In addition, to take full advantage of tax savings, you may need to pay a portion of your profits from the rental property to yourself as a salary, which requires payroll processing.

See Chapter 2 for more about the options for structuring your residential rental business.

Taking Ownership of a Rental Property

Assuming you've completed the closing on your rental property, you realize that transferring ownership of any real estate is a fairly complicated endeavor. The process is even more complicated and perilous when transferring ownership of a rental property. When you buy a rental property, make sure you get the following items from the seller:

- ✓ A list of personal property included in the sale
- ✓ All resident files
- ✓ Seller-verified rent roll and list of all security deposits
- ✓ All required governmental licenses and permits

- ✓ Recent utility bills that are due
- ✓ Every service agreement or contract
- ✓ Copy of the seller's current insurance policy

Chapter 3 contains additional information about these items.



Meet with a reputable insurance provider and purchase a policy for the property prior to taking possession, so there's no lapse in insurance coverage before you take possession. If the property burns down before closing, it's the seller's problem. If an uninsured property burns down after closing, it's your problem. For more about choosing an insurance policy that provides sufficient coverage, see Chapter 3.

After you become the proud owner of the rental property, you have a few tasks to attend to as soon as possible, including the following:

- ✓ Meet with the residents in person, introduce yourself as the new owner, and answer any questions they ask.
- ✓ Inspect the outside of the rental property carefully and make a list of any maintenance and repair issues. Address these issues as soon as possible.
- ✓ Evaluate the current rent. You can't raise the rent for current residents until their lease expires or the end of the month (for month-to-month renters), but analyze how much rent your residents are paying now, and how much you need to charge new residents to turn a decent profit and how much to raise the rent for existing residents when that time comes.
- ✓ Prepare rental contracts (either a fixed-term lease or a month-to-month rental agreement), so they're ready for new residents and for current residents who decide to remain after their rental contract expires.

Avoiding the Legal Pitfalls of Managing Residential Rental Properties

Owning residential rental property comes with legal obligations and risks. You're legally responsible to comply with fair housing laws, keep your property in "habitable" condition, ensure your residents' rights to "quiet enjoyment" of the property, comply with laws for handling and refunding security deposits, take reasonable steps to prevent crime, and eliminate any dangerous or hazardous conditions. If you have employees, you may be liable for their legal actions, as well. And residents can file a claim against you for any number of reasons, regardless of whether those claims have legal merit.

These sections highlight many of the most common legal issues you need to be aware of. We also guide you in best practices that help you avoid legal problems in the first place, such as screening applicants carefully and honoring your residents' legal rights.

Obeying fair housing laws

Fair housing laws prohibit landlords from using certain criteria, such as race or sex, to target residents in advertising or to refuse housing to applicants. When screening applicants, for example, you're permitted to consider only factors that are likely to indicate whether the person will pay her rent on time, take care of the property, get along with the neighbors, and comply with your other policies. You may use criteria such as income, credit history, past evictions, criminal history, and similar factors to determine the prospect's qualifications. You can't use race, skin color, religion, or certain other criteria.

In the following sections, we explain the federal Fair Housing Act and look at how some states expand coverage of that Act. We also stress the importance of considering fair housing laws when advertising your rental property.

Federal law: The Fair Housing Act

The Fair Housing Act prohibits you, as landlord, from discriminating against or giving preferential treatment to people based on a *protected class* — a characteristic that can't be used to discriminate against or in favor of an individual or group. The Fair Housing Act specifies the following seven protected classes:

- ✓ **Race:** Ethnicities or cultures, such as African American, Caucasian, Hispanic, Asian, or American Indian
- ✓ **Religion:** Christianity, Islam, Judaism, Hinduism, and so on
- ✓ **National origin:** The country or area a person was born in, such as Canada, Mexico, the Middle East, or Nigeria
- ✓ **Sex:** Physical sex — male or female
- ✓ **Color:** Skin color or shade, which may seem to be the same thing as race, but people of the same race sometimes discriminate against one another based on lightness or darkness of skin
- ✓ **Handicap:** Physical or mental handicaps or disabilities, including hearing and visual impairments, chronic alcoholism, and HIV/AIDS
- ✓ **Familial status:** Whether a person or couple has children



Consider only those characteristics that reflect the likelihood that the person will pay rent in full on time, treat your rental property with care, and get along with her neighbors. As a landlord, you should consider nothing else.

State and local laws

Some states and municipalities have extended the Fair Housing Act to other protected classes, including the following:

- ✓ Marital status or changes in marital status
- ✓ Sexual orientation or domestic partner/civil union
- ✓ Age
- ✓ Source of income
- ✓ Creed (belief system)

For more about the Fair Housing Act, protected classes, and state additions to the Act, see Chapter 5.

Advertising within the law

Fair housing also comes into play when you're marketing and advertising your property. To comply with fair housing laws in advertising, follow these four general guidelines:

- ✓ Avoid any obviously discriminating words and phrases that state or imply that certain protected classes are unwelcome or that you prefer a certain type of clientele, such as singles, married couples, or affluent individuals.
- ✓ If you use photographs or pictures of people in your advertisements, make sure they convey diversity in race, sex, familial status, and so on.
- ✓ Don't use location, place names, directions, and so on that may suggest exclusion or preference for a certain protected class. For example, stating that the property is near a certain country club or religious facility may be construed as a preference for some prospects while discriminating against others.
- ✓ Include the US Department of Housing and Urban Development's (HUD's) Equal Housing Opportunity logo or statement on all advertising to invite people of all protected classes to apply.

Most landlords avoid blatantly discriminatory language and images in their advertisements. They're more likely to inadvertently commit a violation by showing a picture of a young white couple, for example, or mentioning that the property is "perfect" for certain classes of prospects.



Have someone who's well versed in federal, state, and local fair housing laws review all of your advertisements before you start running them. For more about complying with fair housing and other laws in your advertising, see Chapter 6.

Setting rents and payment policies

Sometime prior to renting out a property, you need to set your rents and payment policies to address the following aspects of rent payments:



- ✔ **Amount:** You want to charge enough rent to cover your operating expenses, earn a decent profit, and remain competitive. In a few cities in a handful of states, you also may need to consider rental rate regulation or *rent control* as well. Visit www.dummies.com/extras/landlordlegalkit and click on the bonus chapter for guidance on setting rents.
- ✔ **Due date:** We recommend having all residents pay the rent in full on the first of the month. If the resident moves in on a day other than the first, then you collect the first month's rent in full and then prorate the second rent payment. This way you collect more money up-front and minimize your risk that your tenant will gain possession of your rental property by just paying you a nominal amount of rent.
- ✔ **Payment form:** This may be cash, check, money order, cashier's check, or online/electronic payment, depending on what you're willing to accept.
- ✔ **Late payments and penalties:** Specify when payments are considered late; for example, "Payments received more than five (5) days after the first of the month are considered late payments." Also specify a penalty, perhaps a 5 percent late fee when the payment is past due.
- ✔ **Penalties for bounced checks:** Penalties may include a flat fee to cover the fee your bank charges you plus a little extra for your time, inconvenience, and aggravation. You may also want to specify that if a certain number of checks bounce, the resident loses the privilege to pay with a personal check.
- ✔ **Penalties for missed payments:** The penalty for missed payments is usually that the resident is required to move out for breach of contract, but you need to specify what a missed payment is; for example, if you haven't received it within 15 days of the due date.

For more about legal issues regarding rent collection and rent control, see Chapter 7.

Screening applicants

Carefully screening applicants is essential to keep your rental units occupied with residents who pay on time, take care of the property, and get along with their neighbors. Careful screening can help you avoid legal issues, because you have less need to take legal action against good residents, and they're less likely to file legal claims against you. To screen applicants, take the following steps:



- 1. Have the person complete and submit an application that includes her name, current address, Social Security number, employment history, rental history, income, and so on.**

Visit www.dummies.com/go/landlordlegalkit and click on the Leasing folder for a sample application.

- 2. Order a credit and background check for the prospective resident.**

You can find several services online that perform credit and background checks. Your application should include language stating that the applicant agrees to a credit and background check.

- 3. Contact the applicant's employer to verify the applicant's employment and income and find out how long the applicant has been employed there.**

You may also want to require copies of pay stubs, recent W-2s and 1099s, the previous year's tax return, and a recent bank statement.

- 4. Contact the applicant's personal references.**

- 5. Contact any landlords the applicant rented from in the past and ask about payment history, the condition the applicant left the property in, and whether the applicant caused problems with her neighbors.**

- 6. Interview the applicant in person.**

Ask why the person is moving and why she chose this area. Ask questions related to information you gathered in previous steps to determine whether what the applicant tells you matches up with what you already know. Inconsistencies can be a red flag.



When screening prospective renters, you must comply with fair housing laws, so certain questions are off-limits. You can gather information about a prospect's employment status, income, credit history, housing history, and criminal past, but you're prohibited from asking an applicant whether she has children, what country she's from, her religion, and so forth. For additional details on how to screen applicants, see Chapter 8.

Drafting a lease or rental agreement

Your rental contract (either the lease or month-to-month rental agreement) establishes the terms that you and your resident agree to, including who's going to be living in the unit and paying rent and for how long, the rent amount and when it's due, the security deposit amount and what it can be used for, your obligations, the resident's obligations, whether pets are allowed and under what conditions, and so on.



We recommend that you start with an existing lease and then modify it to suit your specific needs. You can obtain a sample lease by doing any of the following:

- ✔ Visit www.dummies.com/go/landlordlegalkit and click on the Rental Contract folder. In Chapter 9, we explain the terms of this lease and modifications you may want to consider.
- ✔ Search the web for your state followed by “lease” or “rental agreement.” Sometimes attorneys or property management companies post the lease or rental agreement they use.
- ✔ Ask a reputable local attorney who specializes in landlord-tenant law or real estate for a copy of a residential lease and a residential rental agreement. You may be able to obtain the lease for free or for a modest fee.
- ✔ Use an online legal service, such as www.rocketlawyer.com to obtain a state-specific lease or rental agreement. (Many of these services advertise “free lease.” The hook is that they lead you through a long process of creating a rental contract and then require that you sign up for the service and provide credit card information. You may be able to sign up for a free week or month of the service to get the contracts you need and then cancel the service.)
- ✔ Contact your local affiliate of the National Apartment Association (NAA) or a similar rental industry group about membership. They often have comprehensive, up-to-date legal forms that comply with all applicable laws for your area available for their members at a reasonable cost.

Managing security deposits

Prior to when a resident moves in, you need to collect the first month’s rent (or prorated rent) along with a *security deposit* — a lump sum that you hold until the resident moves out in order to cover the cost of any unpaid rent and damages (beyond ordinary wear and tear). As we explain in Chapter 10, you should have a security deposit policy in place that specifies the following:

- ✔ **Amount:** Usually no more than the equivalent of one- or two-month’s rent. Some states and municipalities have specific limits.
- ✔ **Due date:** Usually due at the signing of the rental contract.
- ✔ **Allowed uses:** State and local laws usually allow landlords to use security deposits only to cover unpaid rent, damages to the unit beyond ordinary wear and tear, cleaning expenses (only to make the unit as clean as it was when the resident moved in), and to restore or replace damaged or missing property, including keys and appliances furnished with the unit.

- ✔ **Where the deposit will be held:** We recommend depositing all security deposits in a separate interest-bearing account and passing along any interest earned (unless nominal) to the resident when you return any unused portion of the deposit.
- ✔ **Return of the unused portion:** Specify the maximum number of days you're allowed to hold any unused portion of the security deposit before returning it to the former resident. State law may establish a limitation.

Moving residents in and out

Two very important days in the course of a resident's stay are the first and the last — the day she moves in and the day she moves out. In the following section, we cover the essential tasks you need to perform on these two days.

Moving a resident in

How well you manage the process of getting a new resident moved in can affect your relationship over the entire term of her occupancy. Get started on the right foot by performing the following steps leading up to and including move-in day:

1. **Agree on a move-in date with the resident.**
2. **Make sure any utilities the resident is responsible for paying are transferred to the resident's name and are turned on no later than the move-in date.**
3. **Review important terms of your rental contract and any addenda to the contract and answer any questions the resident asks.**
4. **Collect the rent and security deposit, if you haven't done so already.**
5. **Inspect the property with the resident, complete a checklist to record the property's condition, and make sure you and the resident sign the checklist.**

We recommend taking photos or a video, so you have a visual record of the property's condition, as well.

6. **Orient the resident to the rental unit and any appliances in the unit, utility shut-offs, and common areas, such as workout facilities, pool, and hot tub.**
7. **Present a move-in letter and a copy of your rules and regulations.**

These documents may include instructions for requesting maintenance and repairs, taking on a roommate, replacing lost keys, paying rent, and so on. You may also include policies for guests, parking, wall hangings, ceiling hooks, pets, and so on.

- 8. Give the resident time to read the move-in letter and the rules and regulations and then have her sign and date two copies of each document — one for her records and one for yours.**
- 9. Give the resident keys to the rental unit and her mailbox.**

For details on moving a new resident in, see Chapter 11.

Moving the resident out

To avoid disputes and litigation after a resident moves out, manage the process the right way. Here's how:

- 1. Require that residents notify you in writing a certain number of days (30 days is common) prior to the date they intend to move out.**
- 2. Present the resident with a move-out letter with instructions on how to prepare the unit for the move-out inspection and a reminder of your policy for returning the security deposit after any deductions for unpaid rent or damages beyond ordinary wear and tear.**

See Chapter 9 for more about what *ordinary wear and tear* means.

- 3. Sign and have the resident sign a termination agreement, so you have documentation that the resident officially moved out.**
- 4. Inspect the unit carefully for any damages or missing items that were furnished with the rental unit, and record your observations on a move-out checklist.**

Take photos or video of any damages.

- 5. As soon as possible, perform the repairs, maintenance, and cleaning required to bring the rental unit back to the condition it was in before the departing resident lived in it.**

Keep receipts for all materials and labor.

- 6. Deduct the costs of any repairs, maintenance, or cleaning that qualify as beyond ordinary wear and tear, and return the remainder of the security deposit (with interest, if required by state or local law) and along with an itemized list of expenses deducted.**

Some jurisdictions require you to provide the former resident with receipts for work done upon request.

Of course, not all residents move out this smoothly. Sometimes, residents simply skip town, abandoning the property without notifying you. In other situations, in which a resident fails to pay rent or breaks the contract in other ways, you may need to either get the resident to leave voluntarily or evict the resident. These exceptions to the standard move-out scenario have special legal procedures you must follow according to state or local law. See Chapter 20 for details about moving residents out and Chapter 19 for more about evictions.

Fulfilling your maintenance and safety obligations

Your rights as a landlord are based upon your rental contract and your state's landlord-tenant laws. Your obligations, however, are primarily in the form of written laws or implied warranties and *covenants* (agreements). In the following sections, we bring you up to speed on your legal obligations to your residents, whether they're in writing or not.

Recognizing your duty to maintain habitable living conditions

According to the *implied warranty of habitability*, you must provide residents with dwellings that are fit to live in. For example, the unit's plumbing and electrical must be in working condition, residents must have running water and reasonable amounts of hot water, the unit must be heated in the winter, common areas must be clean and sanitary, and you must exterminate in response to infestations of rodents and vermin.



If you fail to maintain habitable living conditions, residents may be permitted by law to withhold rent, have the repairs done and bill you for them, sue for damages, take legal action to force you to solve the problems, or move and terminate the lease. See Chapter 12 for details about your obligation to honor the implied warranty of habitability.

Addressing potentially dangerous conditions

Accidents happen regardless of how careful people are, but if anyone is injured on your property as a result of something you did or neglected to do, you could be held liable for the person's medical bills and lost pay and may even be subject to punitive damages (for any reckless or intentional acts that cause injury). Here are a few areas to consider focusing your safety program on:

- ✓ **Fire safety:** Educate residents on the most common fire hazards, provide and maintain fire extinguishers and smoke detectors, and provide residents with a copy of your evacuation procedures. Your local fire department can help you comply with the fire-safety codes in your area. Carbon monoxide detectors are also important if you have gas appliances and are now required in some jurisdictions.
- ✓ **Pool and hot tub safety:** If you have a pool or hot tub, enclose it with fencing and gates that comply with your local building codes, and post required signage to inform residents and their guests of your rules, such as no diving allowed and adult supervision required for children.
- ✓ **Exterior lighting:** Make sure parking lots, stairways, walkways, and entryways have adequate lighting to keep people from tripping or bumping into things.

- ✓ **Safety within units:** Use safety or tempered glass in shower stalls or tub surrounds, use window coverings that have safe cords, make sure all windows have working locks and screens, use outlets with ground fault protection near water (in bathrooms and near the kitchen sink).
- ✓ **General maintenance issues:** Fix any loose railings, stairs, or handrails; repair uneven pavement in sidewalks and parking lots; replace burnt-out exterior lights; and so on. Shovel and de-ice walkways in the winter. Make sure that you immediately mop up any spills and that you place signs to warn residents when floors are wet/slippery.
- ✓ **Set and enforce pet policies:** If you allow pets, make sure your residents comply with local leash laws, at the very least.
- ✓ **Construction site safety:** Make sure contractors secure their construction sites to prevent injuries to curious children and adults.



Team up with residents to improve safety. Encourage them to report any safety concerns to you, respond immediately to their concerns, and thank them for their efforts. For more about improving safety, see Chapter 13.

Disclosing and responding to environmental hazards

We define *environmental hazard* as anything that may adversely affect a person's health, including the following:

- ✓ Asbestos
- ✓ Carbon monoxide
- ✓ Formaldehyde
- ✓ Radon
- ✓ Lead paint
- ✓ Toxic mold
- ✓ Hazardous wastes, including chemical residue from meth labs
- ✓ Pests, including rats, mice, roaches, and bedbugs

Each of these hazards has specific laws regarding the landlord's obligation to disclose and address.



The best course of action isn't always to remove an environmental hazard. In fact, attempts to remove harmful substances, such as asbestos, lead paint, and toxic mold, may increase the danger. If you notice an environmental hazard, head to Chapter 14 to find out how to proceed.

Protecting residents and workers from criminal activity

Landlords are legally obligated to take reasonable steps to prevent crime on their property, which is a job that's more challenging than most landlords realize. If a crime occurs on your property and the courts find that you could have, should have, and didn't take measures to prevent it, you may be held liable for any injuries or property losses that result. Here are several of your primary responsibilities for protecting residents and workers from criminal acts:

- ✔ **Provide and maintain basic security features**, including doors with dead-bolt locks and peepholes for rental units, key locks, or keyless (smart key) for external doors, windows with working latches and insect screens (and in some jurisdictions, locking devices), and sufficient security lighting.
- ✔ **Report suspected criminal activity to local law enforcement** and inform residents of any significant criminal activity in the area that comes to your attention.
- ✔ **Evict residents who commit crimes**, within a certain number of days of being notified by local law enforcement.
- ✔ **Safeguard sensitive resident information** to prevent identity theft and other crimes.
- ✔ **Secure master and duplicate keys** to prevent unauthorized entry to rental units. This also applies to common areas if they're access controlled and to the extent that it's reasonably feasible.
- ✔ **Conduct criminal background checks on prospective employees** and monitor employee activity for any signs of criminal activity.



Team up with local law enforcement agencies. Many law enforcement agencies have pamphlets or booklets (some available online), with valuable guidance on how to secure rental properties. Refer to Chapter 15 for more information.

Knowing the limitations on your right to enter the premises

Landlords frequently believe that because they own the rental property, they can enter rental units whenever they want. You do have a right to enter rental units you own, but your right of entry is balanced against the *covenant of quiet enjoyment* that gives a resident the right to undisturbed use of the property. In most states, a landlord can enter a residence only under certain conditions, some of which require the landlord to give reasonable advanced notice, and some that don't:

- ✔ You can legally enter a rental unit without notice to respond to an emergency that threatens life or property, when a resident has abandoned the property, when responding to a court order, or when you ask for and a resident gives you permission to enter.

- ✓ You can legally enter a rental unit with reasonable notice to check smoke detectors and carbon monoxide detectors, inspect for and make necessary repairs, check for problems during a resident's extended absence, or show the property to a prospective renter, buyer, or lender.

For more about your right to enter the premises and a resident's right to quiet enjoyment, see Chapter 16.

Dealing with cotenants, sublets, and assignments

Every landlord recognizes the importance of screening applicants before permitting them to move into a unit. Unfortunately, residents often try to move others into their unit without your permission by taking on a roommate, subletting the unit to someone else, or assigning their lease to someone you don't know. Such practices significantly increase your exposure to risk, because it opens your doors to people who have no contractual obligation to you. You're not given the opportunity to screen the person, and you don't have the power of a legal contract to enforce your rules.



Screen everyone prior to allowing them to live in one of your rental units. Have the person complete an application, and then follow your standard screening procedure, including performing background checks. If you give approval, make sure the person signs a rental contract. A roommate may simply sign the existing rental contract. Instead of subletting and assignments, we recommend terminating the previous resident's lease and creating a new one for the new resident. For additional details about roommates, sublets, and leases, see Chapter 18.

Terminating rental contracts

All good things (and bad things) must come to an end, and the same is true of rental contracts. The process differs depending on whether you're terminating a lease or a rental agreement and on the circumstances surrounding the termination:

- ✓ **Lease:** A *lease* is a rental contract for a fixed-term, usually one or two years. You can terminate a lease in any of the following three ways:
 - Let it expire and don't renew it. In this case, you should serve your resident a Notice of Nonrenewal 30 or 60 days prior to the date on which the lease expires.

- Mutually agree with your resident to end the lease, in which case you should both sign a Mutual Termination of Lease Agreement.
- Require that the resident move out for breach of contract. In this situation, you must serve the resident a termination notice giving her a certain number of days to move out.

✓ **Rental agreement:** A *rental agreement* is a month-to-month contract. You typically can terminate a rental agreement with or without cause:

- **With cause:** If the resident breaches the contract, you may be able to require that the resident move out in as little as a few days.
- **Without cause:** In most states, you can end a rental agreement without cause, as long as you give the resident sufficient notice, typically 30 to 60 days prior to the termination date.

For more about terminating rental contracts and obtaining the required notices and forms, see Chapter 19.

