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PRE-POSSESSION AND POST-POSSESSION AGREEMENTS

The Real Estate Commissioner's Rules include the following warnings to real estate licensees concerning what are referred to as "pre-possession" and "post-possession" occupancy agreements:

> J. A salesperson or broker shall not:
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> 1. Permit or facilitate occupancy in a person's real property by a third party without prior written authorization from the person; or
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> 2. Deliver possession prior to closing unless expressly authorized to do so by the owner of the property or property interest being transferred.
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> K. A salesperson or broker shall recommend to a client that the client seek appropriate counsel from insurance, legal, tax, and accounting professionals regarding the risks of pre-possession or post-possession of a property.

A.A.C. R4-28-1101(J & K).

What are such agreements? A "pre-possession" agreement means an agreement by which the buyer is permitted to take possession of the property prior to (or "pre") closing. A "post-possession" agreement means an agreement by which the seller is permitted to retain possession for a certain period after (or "post") closing. They are somewhat awkwardly named; it would make more sense to refer to such agreements as "pre-closing possession" agreements and "post-closing possession agreements," respectively.

In years past, pre-possession agreements carried some notoriety in the residential real estate industry, and for good reason. There are several potential dangers associated with such arrangements, and when they go bad, they do so badly. More than one residential real estate "horror story" can be attributed to a pre-possession arrangement gone awry. Hence the reason for the Commissioner's Rules on this issue.

Pre-possession arrangements (and post-possession agreements) can serve a valid purpose for the buyer and seller, but must be done with great care. Following is a general discussion of pre-possession agreements and things one should consider.

A. Pre-Possession Agreements

The most substantial risk with regard to a pre-possession arrangement usually falls upon the Seller. If the Buyer cannot close, the Seller then is left with a tenant. Because the Seller is trying to sell, not lease, he does not want a tenant, much less shoulder the obligations of landlordship. The Buyer may be either unable or unwilling to simply leave immediately after closing fails. The Seller will naturally have a hard time finding another buyer until the tenant leaves.

Furthermore, while the Buyer is occupying the property prior to closing, he may get cold feet or "buyer's remorse" because the property no longer feels right, or because the Buyer becomes aware of various things that detract from the desirability of the deal the Buyer has agreed to. The Buyer may change its mind as to whether to purchase the property, or attempt to rewrite the purchase contract.

There is also the possibility of damages to the property during the Buyer's occupancy prior to closing. Whether such damages are caused by the Buyer, the question will arise as to who assumes the risk.

The Seller's best protection is to put the agreement in writing. The Seller can also protect itself somewhat by obtaining a sufficient security deposit to cover rent (both anticipated and unanticipated) and damage to the property. This agreement is a lease, plain and simple, despite its "pre-possession agreement" name.

The agreement should address all of the terms that one would expect to be contained in a normal residential lease. The parties should consider the application of the Arizona Residential Landlord Tenant Act, A.R.S. §§ 33-1301 *et seq.*, which applies broadly to all residential leases, with certain exceptions. While the exceptions include occupancy under a contract of sale, this exemption does not apply, because a "contract for sale" (also called an agreement for sale) is legally very different from a purchase and sale agreement. There may be numerous reasons and arguments why the Act should not be applied to short-term pre-possession agreements, however, those reasons do not appear in the provisions of the Act. Therefore, the safe course is to assume that Act applies.

Various provisions in the Act that should be considered include the restrictions on advance rent, security deposits and refunds (A.R.S. § 33-1321), the landlord (Seller's) obligation to maintain the premises (A.R.S. § 33-1324), and the landlord's remedies for breach by the tenant (Buyer), A.R.S. §§ 33-1361, *et seq*. The parties may consider referring to specific provisions of the Act as being not applicable, but only with great caution. If the parties simply recite that the Act is waived, the waiver will be ineffective as against the Buyer (tenant), because the Act expressly prohibits any agreement under which the tenant waives or foregoes rights or remedies provided under the Act.

The parties should also consider and address the following issues:

1. Buyer's right to continue to occupy the premises of the sale does not close as scheduled.
2. Amount of rent and security deposit to be paid by Buyer.
3. Buyer's responsibilities to maintain the premises.
4. Responsibility for payment of utilities, and when utilities are to be transferred into Buyer's name.
5. Seller's obligation if the premises are damaged or something breaks prior to closing.
6. Insurance on the premises; Seller's insurance may no longer be effective upon Buyer's occupancy.

Following are suggested provisions that address the above concerns.

Termination Date. From the Seller's perspective, the agreement should state that if the sale does not close on the scheduled closing date, the Buyer's right to occupy the premises terminates on that date. The Seller may want the agreement to state that the cancellation provision (if one is in the purchase contract) shall not extend the termination date (and in fact, the Seller may want the Buyer to remove the cancellation provision altogether). The agreement should state that if the Buyer has not closed by the scheduled date, the Seller may immediately file an action in court for recovery of the premises, without the necessity of any prior notice. The parties should also address what happens if the sale doesn't close in time by reason of the Seller's default.

Rent and Security. If the Buyer will pay rent for the use of the premises prior to closing, the exact amount should be specified in the agreement (either as a daily, weekly or monthly basis, or a flat rate). The Sellers should obtain a security deposit just as with any other type of rental situation.

Risk of Loss or Damages. Generally, the risk of loss or damages to the premises should be borne by the Buyer, though this is negotiable. The Seller should require the Buyer to pay for both casualty and liability insurance during the interim occupancy period. In other words, the Seller should be insured against damage to the premises (e.g., theft, fire, storms, etc.) and against claims for accidents on the premises (e.g., slip and fall, etc.). The Seller should also require the Buyer to agree to a "hold harmless" provision, stating that Buyer will indemnify and not hold Seller responsible for such losses or claims. The best protection for the Seller against such matters, however, will be the insurance.

Condition of the Premises. Presumably, the Buyer will have had the opportunity to inspect the premises prior to occupying the property. From the Seller's viewpoint, the agreement should state that the Buyer has inspected the premises and agrees to accept the property in its existing condition except that the Seller agrees to repair the specific items listed in the occupancy agreement, if any such exceptions exist. From the Buyer's standpoint, the Buyer will not want to waive the Seller's warranties in the purchase contract relating to the condition of the premises at closing (e.g., that the roof will be watertight, that appliances will be in working order, etc.). The parties must agree how to handle this issue **before** the Buyer is given the keys to the premises.

B. Post-Possession Agreements

The post-possession occupancy agreement is essentially the flip-side of a pre-possession occupancy agreement. It is an agreement between the buyer and seller where the seller remains in the property after closing, and title has passed to the buyer. Stated generally, the post-possession agreement does not carry the same risks as a pre-possession agreement. Unlike the pre-possession agreement, the post-possession agreement does not depend on closing of the sale, but rather becomes effective upon successful closing. If the sale does not close, the seller stays in the property as before. Whether the parties get into a dispute, extend the closing date, or simply walk, the issue of post-possession occupancy never comes to bear. If the sale does close, then the buyer and seller become landlord and tenant, period. There isn't the problem of a future closing, or the buyer getting cold feet during the tenancy and backing out, or the seller being left to find another buyer while dealing with the ex-buyer tenant.

Nevertheless, as the Commissioner's Rule contemplates, a post-possession agreement does involve certain risks that must be considered. As with the pre-possession scenario, the agreement should be put in writing, and can be a standard residential lease with due attention to the provisions of the Arizona Residential Landlord Tenant Act ("ARLTA"), A.R.S. §§ 33-1301 *et seq.*, which applies broadly to all residential leases. Following is a summary of many of the risks and matters to be addressed in the agreement.

Lease term. Oftentimes the seller is seeking to remain in the property until he or she can close on the purchase of another property and then move. Assuming this is the case, the seller will want to specify a tenancy term that approximates the estimated time to close on the new house, with an automatic right of renewal for successive specified periods. The buyer will probably prefer a non-renewable lease term for a relatively short period of time, assuming the buyer plans to move in when the seller leaves and wants to be able to plan ahead. The buyer should ask that the agreement state that any extensions shall require buyer's written approval, that no notice of termination shall be required, and that the buyer has the right to the termination date shall not be extended except upon the buyer's written approval, and that the Buyer is not obligated to send any notice of termination. If the buyer has purchased the property as an investment, however, the buyer will have much greater flexibility on the lease term and may be delighted to have a tenant immediately upon closing.

Rent and Security**.** The buyer should ask for rent and a security deposit to be paid upon closing, and if possible, as a credit against the purchase price. The amount of the security deposit and advance rent required, however, should not exceed one and one-half months' rent. *See* A.R.S. § 33-1321. In determining the amount of rent, the parties should consider not only the debt service if any, but also matters such as homeowner association fees and property taxes. In addition, the parties should specifically provide in the agreement who will be responsible for utilities.

Risk of Loss or Damages. As in the pre-possession scenario, the owner (now the buyer) should try to shift the risk of loss or damages to the tenant (the seller). Of course, and again as in the pre-possession scenario, insurance is the key. The buyer should obtain casualty and liability insurance on the property at closing, just as if she were taking possession. The buyer may seek to have the seller pay the insurance premium during the occupancy period, certainly if the premium is higher than it would otherwise be if the buyer were taking possession. The buyer should also require the seller to purchase a home warranty policy to cover appliances and other items that the seller will continue to use during her occupancy.

The seller, conversely, should be mindful that her homeowner's policy is no longer in effect, and the contents of the home will not be covered by the policy purchased by the buyer (and new owner). The seller should consider purchasing a renter's policy to insure any of the contents that she owns and is keeping in the house during the tenancy period.

Condition of the Premises. It is very important that the buyer and seller address any issues concerning the condition of the premises prior to closing, just as if the buyer were immediately moving in. The buyer should not neglect to perform an inspection, and prior to closing, a final walkthrough, to ensure that everything is as it should be and that any potential problems are addressed and resolved. The fact that the seller is remaining in the property does not alter the fact that the buyer is taking ownership of the property and all that ownership entails. Leaving things to be done by the seller during the ensuing tenancy will leave them less likely to be addressed. It is also in the seller's interest to avoid making any commitments to do further repairs or work on the property during the tenancy, and ensure that the buyer commits to take the property as is at the time of closing.

Moreover, matters that arise after closing, such as leaky pipes or the air conditioner breaking down, will be the buyer's obligation to repair and maintain as the landlord.[1] The buyer arguably can protect herself by requiring the seller to warrant that the condition of the property at termination of the tenancy will be the same as at closing. Suffice to say, however, any troubleshooting should be done before the buyer becomes the owner and landlord. The final walkthrough is also as good a time as any for the buyer to have the seller do her prospective tenancy inspection and complete a checklist concerning the condition of the property.

[1] Under the ARLTA, the landlord is limited in most respects from shifting responsibility to the tenant to keep the premises in a fit and habitable condition and maintain electrical, plumbing, sanitary and ventilation services and appliances. *See* A.R.S. § 33-1324.