

# Kimball, Tirey & St. John LLP

## The Commercial Security Deposit: Do's and Don'ts

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The differences between commercial and residential security deposit collection, retention and disposition are significant. Unlike the near “contracts of adhesion” residential tenancy agreement provisions connote, commercial property owners have far greater freedom to negotiate security deposit provisions. Courts and legislation consider big bad old residential landlords to be an evil that must be tolerated and regulated. Commercial landlords, on a presumed more level playing field, are popularly regarded as those who just want to make money for fun and profit. For all landlords, whether they are the ilk of Snidely Whiplash or Sister Teresa, a more socially acceptable goal is to update leases and foster entanglement avoidance.

### **Collecting the Security Deposit**

Commercial security deposits here are governed by California Civil Code Section 1950.7. There are no restrictions on the amount a commercial security deposit may be, it is simply what the market will bear. There are some controls, for example a commercial landlord's inclination to demand payment as a condition to starting, continuing or renewing a commercial lease (loosely defined: “key money”) is unlawful unless the amount of the payment is stated in the written lease entered into by the landlord and tenant. Note any attorney fees the lessor incurred in preparing the lease that is to be passed on to the lessee must be expressly stated in the lease.

### **Retention of Security Deposit at Termination of Tenancy**

Unlike the prohibitions in California Civil Code Section 1950.5 (residential security deposit statute) California Civil Code Section 1950.7 does not preclude a landlord from requiring a security deposit be non-refundable. Query however, if such were the case, and no rental, damages or cleaning were owed at termination of the lease, such retention would be considered an unlawful business practice, or disguised “key money”. Generally the security deposit is to be solely used as reasonably necessary to repair damages caused by the tenant, remedy nonpayment of rent as of premises' turn over, or clean the premises, subject to the usual “ordinary wear and tear” presumptions.

### **Security Deposit Accounting Requirements**

Unlike residential, a commercial landlord is not obligated to provide a tenant with an itemized statement regarding the disposition of the security deposit unless the parties provide for this requirement in the lease agreement. The landlord is required to send the check, for the difference remaining, within a fixed period of return of realty possession.

### **Refunding the Security Deposit for Nonpayment of Rent Only**

If a commercial landlord's only claim to retain the security deposit is for default in payment of rent, the refund deadline depends on whether the deposit covers more or less than one month's rent. If the deposit covers no more than one month's rent plus an amount described as payment of the last month's rent, any deposit left over must be returned to the tenant at a mutually

agreed upon time but no later than 30 days from the date the landlord receives possession of the premises. Again assuming only rental deductions, where the deposit covers more than one month's rent plus last month's rent, any balance of the deposit exceeding one month's rent must be returned to the tenant no later than two weeks after the date the premises are tendered to the landlord with the remainder to be returned or accounted for within 30 (calendar) days from the date the landlord received possession of the premises.

In the absence of language in the lease waiving the limitations of Civil Code 1950.7, a trial court in San Francisco (Sherwood Partners v. Zoro) has held the security deposit may not be applied to future rent damages, prejudgment interest and attorney fees and costs that a landlord might recover in an action for breach of contract under California Civil Code Section 1951.2. Query whether the rights of equitable offset per California Code of Civil Procedure Section 431.70 provide complete relief to avoid a lack of exculpatory language waiving the CC 1950.7 restrictive applications, the concern being a quasi-equitable remedy may not supersede legal dictates. In other less legalistic words, may one offset the security deposit law's violation with a greater amount of post termination rental loss damages, even though the lease doesn't specifically allow it? No appellate case on point as yet.

If the tenant abandons the premises before the end of the lease term, the landlord may choose not to disturb the remainder leasehold and file an action for damages for the rent still owed through the life of the lease. The tenant may sublet the premises or assign its interest in the lease in such a case. The landlord would not get back possession of the premises, and, as such, the security deposit may be applied toward the rent as it becomes due. Under this scenario, upon exhaustion of the security deposit and further rental accrual, a notice to pay or quit may issue and unlawful detainer proceedings may result. ***Having a tenant's forwarding address to implement such a remedy could prove to be critical when examining time lines for this prerogative. Evicting a "long gone" tenant takes seemingly forever, with service problematic and the odds a default judgment would be set aside greatly increased, wasting months and money.***

### **Refunding the Security Deposit for Repairs or Cleaning**

Whether rental remains unpaid or not, when making deductions which include commercial property damage or cleaning, any balance must be returned to the tenant at a time mutually agreed upon by the parties but no later than 30 days from the date the landlord receives possession of the premises.

### **The Penalties**

The damages for bad faith retention of a commercial property tenant's security deposit is subject to statutory damages of up to \$200 plus the tenant's "actual damages," which are recoverable in a civil action brought by the tenant. Additionally, the landlord could be subject to a civil suit for an unfair business practice. Clearly one case could beget many, caveat to the landlord, avoid being a class action defendant! Update your lease to allow application of the deposit to ***all damages*** caused by lease default/termination, and waive application of California Civil Code Section 1950.7. Happy leasing all!

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