

Kimball, Tirey & St. John LLP

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

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Updated April 2026

The differences between commercial and residential security deposit collection, retention and disposition are significant. Courts and legislators presume an unequal bargaining position between residential landlords and tenants and regulate residential landlords more heavily, but presume commercial landlords and tenants are on a more level playing field and therefore allow more freedom to negotiate security deposit provisions.

Collecting the Security Deposit

Commercial security deposits are governed by California Civil Code § 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 on the collection of the security deposit; For example, a commercial landlord cannot demand payment as a condition to starting, continuing or renewing a commercial lease (loosely defined: “key money”), unless the amount of the payment is stated in the written lease entered into by the landlord and tenant. Note that any attorney fees the landlord incurred in preparing the lease that are to be passed on to the tenant must be expressly stated in the lease.

Retention of Security Deposit at Termination of Tenancy

Generally, §1950.7 allows the security deposit to be used as reasonably necessary to repair damage caused by the tenant, remedy nonpayment of rent as of the premises’ turn over or clean the premises. However, California courts have ruled that § 1950.7 can be waived by provisions in the lease to expand the landlord’s ability to retain the security deposit. For example, most commercial leases have a carve out for ordinary wear and tear, especially if the tenancy spans several years.

In the absence of language in the lease waiving the limitations of Civil Code § 1950.7, a trial court and appellate court in San Francisco ([Sherwood Partners v. Zoro](#); [250 L.L.C. v. PhotoPoint Corp.](#)) have 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 Civil Code § 1951.2. Therefore, if the tenant abandons the premises before the end of the lease term and the lease does not allow the landlord to deduct future rent from the security deposit, the landlord may choose not to disturb the remainder lease term, subject to the landlord’s duty to attempt to diligently relet the premises, and file an action for damages for the rent still owed through the life of the lease.

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 equal to or less than one month’s rent plus an amount described in the lease 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.

Refunding the Security Deposit for Repairs or Cleaning

Whether rent 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.

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, as described above.

The Penalties

The damages for bad faith retention of a commercial property tenant's security deposit are 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, which are often brought in the form of a class action lawsuit.

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. Contact info@kts-law.com for a lease review or advice regarding commercial security deposits.

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