

# **SECURITY DEPOSITS AND SUBLEASE ISSUES**

## **Presentation to CCIM**

**JANUARY 8, 2001**

Richard C. Mallory

Allen Matkins Leck Gamble & Mallory LLP

333 Bush Street, Seventeenth Floor

San Francisco, California 94104-2806

 (415) 837-1515     (415) 837-1516

## **Security Deposits and the Effect of Section 1950.7 of the California Civil Code**

1. Applies to any payment or deposit which is to secure the performance of a non-residential lease.

2. Landlord may claim only amounts "necessary to remedy tenant defaults in the payment of rent, to repair damages to the premises caused by tenant or to clean the premises upon termination of the tenancy."

3. If the claim is only for defaults in the payment of rent, then remaining portion must be returned to the tenant within two weeks after Landlord receives possession of the premises.

4. Bad faith retention may subject the Landlord to damages

5. Statute should be waived in all commercial leases.

6. Public Employees Retirement System v. Winston.

(i) never lease to a lawyer.

(ii) PERS purchased the building, in SF, after the Tenant had leased for five years. Services were reduced and the Tenant claimed constructive eviction. He stopped paying rent in February and moved out on May 5, 1984, when there were still three years remaining on his five year lease. Trial court held that the lease was terminated when the Tenant moved out by virtue of the constructive eviction by PERS.

(iii) PERS kept Tenant's \$5,000 deposit because it believed it could get damages of about 100,000. Because PERS lost on the constructive eviction argument, PERS wasn't entitled to any damages for future rent and had to offset past rent by the amount of the deposit.

(iv) Very interesting case. Cited by recent bankruptcy journal article by Michael St. James as authority for the proposition that future damages cannot be charged against a security deposit. The security deposit, according to St. James, must be returned to the tenant after past damages, at the time of the surrender of possession, are withdrawn by the Landlord from the security deposit. St. James has taken on a contingent fee case on this issue, so we may hear more.

(v) What to do? Statute not clear on what it means to "remedy the tenant's default in the payment of rent." Landlord's will have to take the position that the payment of damages on account of future rental is a permissible deduction from the security deposit. Send the Tenant a letter within two weeks of obtaining possession outlining the basis for deductions from the security deposit.

(vi) Keep lease alive under 1951.4 – possession remains in the tenant, technically, until the lease is terminated by the Landlord.

7. Effect on an LC. Some LC's provide that the amounts drawn under the LC's are to be treated as a security deposit. Argue that the amount is not a "payment or deposit" to secure performance of a lease; rather, the proceeds under a LC are received because of a default. This problem should be addressed in future LC's.

## **Subleases**

1. Distinction between Assignment and Sublease in California
2. Information the Landlord Should Obtain.
  - a. Financial Strength of Subtenant
  - b. Investigate and Limit the Proposed Use by the Subtenant
    - (i) Does the Proposed Use constitute a change in use under the Building Code or the Planning Code?
    - (ii) Standards and Conditions for Change in Use Civil Code 1997.210, et seq.
    - (iii) January 1, 1992
  - c. What are the Subtenant's proposed alterations
    - (i) Will they trigger exiting or fire separation issues
    - (ii) Will alterations trigger any ADA or Title 24 access issues
      - Path of Travel –  
  
Alterations Where the Cost is below the ENR Average Construction Cost Index (US 20 Cities Average Construction Cost Index published by the Engineering News Record): 20% Rule (if below the ENR threshold, currently \$93,131.86, must still spend 20% of the cost.)  
  
Alterations Where the Cost is Above ENR Average Construction Cost Index: No maximum.
  - (d) Form of Proposed Sublease
    - (i) Incorporation by Reference
      - Carve Outs (options, approvals, maintenance, replacement and insurance)
      - Specific Inclusions (key provisions like use restrictions)

- (ii) Waiver of Claims and Subrogation by the Subtenant
- (iii) Obtaining Approvals from Landlord
  - Obtaining approval before exercising expansion or extension rights
- (iv) Copies of all notices should be provided to Landlord.
- (v) Inspection Rights
- (vi) The "Lost Profits" trap
- (vii) Assumption by the Subtenant
- (viii) Insurance issues
- (e) Form of Proposed Consent
  - (i) Clarify that the Tenant remains liable
  - (ii) Subtenant should assume the obligations of the Master Lease that apply to the Subleased Premises
  - (iii) Agreement not to terminate or amend Sublease
  - (iv) Agreement to pay rent to Landlord, and, at Landlord's election, to attorn
    - Landlord not liable for prepayments
    - Landlord not liable for pre-attornment breaches
    - Landlord not liable for return of security deposit
    - Landlord not subject to defenses or offsets
  - (v) Agreement to pay attorneys' fees

### **Protection for the Subtenant**

1. Obtain a Recognition/Non-Disturbance Agreement (Mallory)
2. Obtain Assignment of Lease
  - a. Benefits to Incoming Tenant
    - (i) Simpler exercise of rights/obtaining of approvals in the future.

- (ii) Avoid lease prohibition on subsubleasing, if any, and simpler transfers in the future.

b. Handling the Rent Differential: Assume the transferring Tenant's rent is above market. If Landlord will amend the Lease to reduce the rent to market rates and enter into an agreement with the transferring Tenant under which the transferring Tenant agrees to pay the amount of the reduction in rent to the Landlord, then the Landlord gets two balance sheets to back the same obligation and a potentially greater overall recovery if the transferring tenant goes bankrupt.

- (i) Agreement to Pay Rent Differential between Assignor and Landlord. If payment in lump sum, could have a preference problem because the payment may be made on account of an antecedent debt. If Payment in installments, may be ok because the payment is made in the ordinary course. No fraudulent conveyance issue here because transferring tenant received reasonably equivalent value in the exchange (e.g. a release of liability to the Landlord).
- (ii) Collateral for Agreement to Pay Rent Differential – Practical problem because not available, generally.
- (iii) Probably would not avoid 502(b)(6) cap against the transferring tenant. May be possible to get a higher total recovery, because the transaction would reduce the total damages against the transferring tenant and add a new source of recovery.