California Bankruptcy Journal™

A Quarterly

RECENT DEVELOPMENTS IN BUSINESS BANKRUPTCY - 2000	*Honorable Edward D. Jellen* *Lawrence Goldberg* *Margaret Sheneman*
LANDLORD BEWARE: WILL A SECURITY DEPOSIT SURVIVE A BANKRUPTCY?	*Michael St. James*
THE TIME LIMITATION FOR OBJECTING TO THE DISCHARGE OF DEBTS: A TRAP FOR THE UNWARY	*Katherine S. Kruis*
SYNOPSIS OF AMENDMENTS TO THE FEDERAL RULES OF BANKRUPTCY PROCEDURE	*Kelly J. Brinkman*
TAX NEWS & VIEWS	*Elmer Dean Martin III*

VOLUME 26 **2001** **NUMBER 1**

Landlord Beware: Will a Security Deposit Survive a Bankruptcy?

Michael St. James

I. Introduction

In Silicon Valley, no one is credit-worthy for long, certainly not for the full term of a long-term lease. Landlords routinely try to "solve" this problem with substantial security deposits: it is not uncommon to see security deposits amounting to many hundreds of thousands of dollars, or even millions of dollars. Indeed, the existence of a large security deposit backing the long-term lease may be essential to the financing structure of the underlying real property.

This article suggests that a security deposit is far less useful than it seems. As a matter of California law, the landlord may be required to surrender the deposit to the tenant's bankruptcy trustee – even though the landlord will suffer damages and losses due to the "rejection" of the lease which exceed the amount of the security deposit; the very damages which the security deposit was intended to protect against. As it turns out, the security deposit may not be good for very much.

II. The Problem

A Landlord's Damages:

A landlord faces four distinct types of damages: two which I characterize as retrospective (because they have matured by the time the landlord regains possession of the premises), two which I characterize as prospective (because they mature in the future). While prospective damages are potentially more substantial, a security deposit can only be applied against retrospective damages.

Retrospective damages are those which have already occurred as of the time the landlord regains the premises. There are two key types of retrospective damages: rent which has already accrued but not been paid ("Pre-Surrender Rent"), and costs to restore the premises to marketable condition ("Restoration Costs"). A security deposit can unquestionably be applied against these types of damages.[1]

---

[1] Cal. Civ. Code § 1950.7(c) (West 2001).

Often, the retrospective damages will be comparatively small: as a result of the comparatively quick unlawful detainer laws[2] – and the priority afforded to post-bankruptcy administrative rent[3] – a landlord's exposure to Pre-Surrender Rent may only amount to a few months' rent. Although restoration costs might be substantial if the landlord must, e.g., restore premises to shell, where the space will be used for office or "standard" R&D purposes, Restoration Costs may amount to no more than removing or restoring a few demising walls.

Potentially the biggest losses a landlord faces are those which will arise *after* the premises are regained ("prospective" damages). These prospective damages are summed up in two questions: "How long will the space stay vacant before I release it?" ("Dead Time") and "How much lower will market rent be when I finally release it?" ("Rent Differential").

While retrospective damages may amount to only a few months' rent, prospective damages can easily amount to more than a year's rent, especially where market rental rates or occupancy levels have softened since the lease was signed. When a landlord demands a security deposit equal to a year's rent, it is not trying to protect against the prospect of retrospective damages: it is trying to address prospective damages by obtaining a source of continued rent payments during the Dead Time, and possibly a source of contributions to any adverse Rent Differential. Will the landlord get to enjoy its security deposit for those purposes? Quite possibly not.

The Statutory Scheme:

"With the possible exceptions of relationships between husbands and wives and employees and employers, no relationship occurs more frequently in California than that of landlords and tenants."[4] In response, California's Legislature has established an extensive statutory scheme which "occupies the field" with respect to much of that relationship.[5]

---

[2] Cal. Civ. Proc. Code. § 1161 *et seq.* (West 2001).

[3] 11 U.S.C. § 365(d)(3) (West 2001).

[4] People v. Parkmerced Co., 198 Cal. App. 3d 683, 693-94, 244 Cal. Rptr. 22, 27 (1st Dist. Ct. App. 1988) (King, J. concurring).

[5] Tri-County Apartment Assn. v. City of Mountain View, 196 Cal. App., 3d 1283, 242 Cal. Rptr. 438 (6th Dist. Cit. App. 1987) (holding that state statutes prescribing the notices which must be given in the landlord-tenant relationship "occupied the field" and pre-empted a

The treatment of security deposits for non-residential[6] property is governed by California Civil Code section 1950.7. That statute begins by broadly defining "security deposit" to include "Any payment or deposit of money the primary function of which is to secure the performance of the rental agreement...."[7] The scope of the term "security deposit" includes everything which is defeasibly given to the landlord to assure performance under a lease.[8]

Section 1950.7(c) limits the application of a security deposit to retrospective damages *only*. The relevant provision is:

> (c) The landlord may claim of the payment or deposit only those amounts as are reasonably necessary to remedy tenant defaults in the payment of rent, to repair damages to the premises caused by the tenant, or to clean the premises upon termination of the tenancy...[9]

Lest there be any thought that permission to use the deposit to "remedy tenant defaults in the payment of rent" applies prospectively to future rent loss,

---

local statute which established notice requirements for increases in rent.)

[6] A separate statute, California Civil Code § 1950.5, governs security deposits for residential real property.

[7] Cal. Civ. Code § 1950.7(a) (West 2001). The First District Court of Appeals found that a fee to cover the landlord's administrative expenses at lease inception fell within the broad language of the statutory definition of a residential security deposit; and since the fees "were [not to be] applied to any of the purposes permitted by [the statutes; i.e., Surrender Rent or Restoration Costs], they were required to be refunded." People v. Parkmerced Co., 198 Cal. App. 3d 683, 691, 244 Cal. Rptr. 22, 25. *But see* Kraus v. Trinity Mgmt. Services, Inc., 23 Cal. 4th 116, 141, 96 Cal. Rptr. 2d 485, 503 (2000) (holding that such an administrative fee was permissible and did not constitute a "security deposit".

[8] *See* Granberry v. Islay Investments, 161 Cal. App. 3d 382, 207 Cal. Rptr. 652 (1984) (where landlord charged substantially greater first month's rent than the rent charged in all subsequent months, it was appropriate for the court to find that the excess first month's "rent" was a "security deposit" for the purposes of this statute); *compare* Kraus v. Trinity Mgmt. Services, Inc., 23 Cal. 4th 116, 141, 96 Cal. Rptr. 2d 485, 503 (2000) (holding that a non-refundable "fee imposed at the outset of the tenancy to reimburse the landlord for expenses incurred for such purposes as providing application forms, listing, interviewing, screening the applicant, for checking credit references and for similar purposes is not a security [deposit] governed by the provisions of [the parallel residential security deposit statute]").

[9] Cal. Civ. Code § 1950.7(c) (West 2001).

the Civil Code imposes a duty on the landlord voluntarily to surrender the balance of the security deposit to the tenant within two weeks[10] after regaining possession of the premises.[11] If the rent to be offset against the security deposit *must* be calculated and the excess returned within two weeks after the premises are surrendered to the landlord, the offset clearly is limited to rent due through the time of surrender.[12]

That conclusion is consistent with the holding of the only California appellate case which directly addresses this requirement.[13] *Public Employees' Retirement System v. Winston*[14] unequivocally holds that the security deposit must be applied against rent arrearages two weeks after the premises have been vacated, rather than permitting it to be retained for application against the prospective damages which the landlord expects ultimately to suffer.

In *Winston*, the trial court permitted the landlord to offset the security deposit against its award for rent arrearages and pre-judgment interest at the time the judgment was entered, many years after the premises were surrendered. Since the deposit was insufficient by a few hundred dollars, the landlord was the

---

[10] If the security deposit is withheld to be applied against cleaning and repair expenses, the landlord has 30 days from the surrender of possession to turnover the security deposit. Cal. Civ. Code § 1950.7(c) (West 2001).

[11] "Where the claim of the landlord upon the payment or deposit is only for defaults in the payment of rent, then any remaining portion of the payment or deposit shall be returned to the tenant no later than two weeks after the date the landlord receives possession of the premises." Cal. Civ. Code § 1950.7(c) (West 2001).

[12] This distinction between retrospective and prospective damages is incorporated into section 1951.2 of the Civil Code, which specifies the damages which a landlord may be permitted to recover on a premature termination of a lease. Rent accrued but unpaid prior to the termination of the lease is automatically allowed under section 1951.2(a)(1). Prospective losses, however, are allowed if at all only under section 1951.2(a)(3) which permits a claim for "the amount by which the unpaid rent for the balance of the term . . . exceeds the amount of such rental loss that the lessee proves could be reasonably avoided," but only if the lease specifically permits it.

[13] The California Supreme Court characterized the parallel statute governing residential security deposits as follows: "From the plain language of the statute we conclude that a landlord . . . must return a tenant's security deposit within the specified period after termination of the tenancy . . ." Granberry v. Islay Investments, 9 Cal. 4th 738, 744-45; 38 Cal. Rptr. 2d 650, 653 (1995).

[14] 209 Cal. App. 3d 205, 258 Cal. Rptr. 612 (1st Dist.1989).

prevailing party on the monetary award, leaving the tenant liable for $25,000 in attorneys' fees.

On appeal, the Court of Appeals held that the offset was to be treated as having occurred two weeks after the tenant surrendered possession of the premises, rather than deferred until the judgment was entered. The Court's holding was direct:

> Winston contends, and we agree, that the foregoing statutory language unambiguously provides that the lessor must credit the deposit against any rent owing within two weeks following the termination of the lease, at which time the lessee becomes entitled to the balance, if any.[15]

Since the security deposit in *Winston* was slightly in excess of the rent arrears at the time the premises were surrendered, the tenant was the "prevailing party" with respect to the money judgment.

It is important to note that the landlord in the *Winston* case was obligated to turn over the balance of the security deposit two weeks after receiving a surrender of the premises *even though* its anticipated prospective damages at the time were immense.[16] Characterizing "the timing of the offset" of the deposit as "critical" to its decision,[17] the *Winston* court squarely held that the command of the statute must be enforced: the landlord must offset the security deposit against only retrospective damages and promptly refund the balance, notwithstanding the magnitude of the landlord's prospective damages.

The conclusion of the *Winston* court is further buttressed by the existence of a penalty provision in the statute, which imposes statutory damages – in addition to actual damages – for the "bad faith retention by a landlord . . . of a

---

[15] Winston, *supra*, 209 Cal. App. 3d at 209, 258 Cal. Rptr. at 614.

[16] The landlord "claimed unpaid future rent and other damages in excess of $100,000." Winston, 209 Cal. App. 3d at 209, 258 Cal. Rptr. at 614. While the landlord ultimately did not prevail on those prospective damage claims due to the tenant's successful constructive eviction defense, that certainly was not anticipated by the landlord two weeks after the surrender of the premises, when the Court held that the excess deposit should have been refunded.

[17] *Id.* at 210, 258 Cal. Rptr. at 614.

payment or deposit or any portion thereof in violation of this section."[18] Since the amount of the statutory damages[19] has not increased since the statute was enacted in 1977, its existence is significant as a strong statement of legislative intent,[20] rather than as an economic disincentive.

California's statutory scheme restricts security deposits to retrospective damages. Typically, a diligent landlord can limit its retrospective damages by requiring a tenant to pay rent or get out, whether through use of the State unlawful detainer procedure or the rights afforded under section 365 of the Bankruptcy Code. It is the landlord's prospective damages which are potentially extensive; those are the damages which landlords often hope to ameliorate through security deposits. Section 1950.7 of the Civil Code dashes those hopes.

Why Doesn't The Problem Arise More Often?

The foregoing suggests that tenants could routinely recover large security deposits from their landlords, even though the landlords face substantial prospective damages. Why doesn't that occur more often?

Outside of bankruptcy, the landlord has a practical remedy which completely solves the problem. The landlord can file suit to collect its prospective damages and seek a writ of attachment, authorizing it to attach its own obligation to return the security deposit to the tenant. The claim for prospective damages is certainly one for which attachment would appear to be an available remedy.[21] The burdens associated with filing suit and seeking a writ of attachment are not particularly substantial. While it might be argued that this type of conduct thwarts the intent of the statute – to compel prompt and voluntary turnover of the tenant's security deposit[22] – it is highly unlikely that any adverse

---

[18] Cal. Civ. Code § 1950.7(f) (West 2001).

[19] The penalty is fixed at $200.00. Cal. Civ. Code § 1950.7(f) (West 2001).

[20] The language has been interpreted, however, as evincing a legislative intent not to "impose a penalty for good faith retention." Granberry v. Islay Investments, *supra*, 9 Cal. 4th 738, 744-45; 38 Cal. Rptr. 2d 650, 653 (1995).

[21] Cal. Civ. Proc. Code § 483.010(a) (West 2001).

[22] The statute was "enacted to ensure the speedy return of security deposits on the termination of tenancy and to prevent the improper retention of such deposits." Granberry, 9 Cal. 4th at 746; 38 Cal. Rptr. 2d at 654 (1995).

consequence would flow to the landlord from seeking a writ of attachment.[23]

Due to the availability of the remedy of attachment, an attempt to limit the application of a security deposit to retrospective damages is likely to prove an idle act outside of bankruptcy, but that certainly is not the case following a bankruptcy filing. Indeed, the bankruptcy laws are intended to prevent one unsecured creditor from getting a "leg up" on the others through an attachment or similar proceeding[24]. So why doesn't the issue come up often in the bankruptcy context?

Ordinarily, the bankruptcy laws treat a creditor who holds a deposit as a secured creditor, with the deposit serving as collateral. To the extent that the creditor holds an enforceable claim, it may obtain relief from stay to apply its collateral against that claim. For example, an attorney's prepetition retainer may be applied against allowed fees, even though that enables the attorney to enjoy a greater recovery on his claim than similarly situated creditors. [25]

---

[23] *See Id.* 9 Cal. 4th. 738, 753 *et seq.*, 38 Cal. Rptr. 2d 650, 659 *et seq.* (1995) (Kennard, J., dissenting). In *Islay*, a residential landlord charged tenants a first month's rent which was substantially higher than the rent for every subsequent month. The courts held that the excessive portion of the first month's rent must be treated as a "security deposit" under California law. The landlord then asserted against each individual member of the class a right to offset the "security deposit" against retrospective damages. Justice Kennard argued that the purpose of [the statute's] carefully calibrated provisions is to compel landlords to refund security due tenants promptly without the necessity of legal action by tenants... The inescapable corollary of the landlord's mandatory duty to assert any claims within the statutory period is that after that period expires the landlord loses any further right to assert claims as setoff against the security.

A majority of the California Supreme Court disagreed with Justice Kennard, however, and held that the statutory penalty of $600 was the exclusive loss the landlord might be required to suffer, and that its failure timely to surrender the security deposit or to assert its offset claims would not be deemed a waiver of those claims. If a landlord does not lose rights by (a) evading the statute by characterizing as security deposit as additional first month's rent, (b) failing to return the deposit for many years, (c) delaying the assertion of its claims until many years after the statutory "deadline" and (d) does all of this in the more tenant-oriented residential context, it seems unlikely that a commercial landlord would lose rights by availing itself of its statutory entitlement to seek an attachment.

[24] *See* 11 U.S.C. § 547 (West 2001); Cal. Civ. Proc. Code § 494.030(b) (West 2001) (automatically dissolving attachments when the debtor files bankruptcy within the subsequent 90 days).

[25] *See, e.g., In re* North Bay Tractor, Inc., 191 B.R. 186, 187 (Bankr. N.D. Cal. 1996) ("The attorney's interest in... a retainer is in the nature of a security interest, assuring the attorney of a minimum fee..."); *In re* Century Cleaning Services, Inc., 215 B.R. 18 (B.A.P. 9th Cir. 1997) (Although debtor's counsel could not be awarded postpetition fees from the estate, fees

The natural assumption is that a landlord who holds a deposit may apply it against any claim the landlord has: if it is likely to face substantial prospective damages, the security deposit may be applied against them. The fallacy in the "deposit as cash collateral" analysis is that the landlord has no legal right to retain the security deposit – as collateral or otherwise – following the expiration of the statutory deadline (two weeks or 30 days after surrender of the leasehold, depending); indeed, it is legally obligated to surrender the deposit to the tenant.[26]

III. So What's a Landlord to Do?

The statute in question is designed to be self-executing[27] and to overcome efforts to "draft around" its results. If the issue is addressed following the surrender of the leasehold, the landlord is limited to advancing one weak argument. Although there is no simple "draft around", if the issue is addressed at lease inception there are some things a landlord can do to reduce its exposure to this issue materially.

Post-Surrender Argument:

There is little that a landlord can do in the face of a statute which is clear on its face. But, the landlord can argue that its security deposit is really an "advance payment" subject to California Civil Code section 1951.7.

Section 1951.7 provides that if a tenant (a) has provided a substantial "advance payment", and (b) has requested such information in writing, the tenant is entitled to receive information about the landlord's post-surrender re-leasing efforts. The landlord could argue that section 1951.7 implicitly recognizes that the "advance payment" will be offset against the landlord's prospective damages, and so the statute addresses the tenant's reasonable desire for information about the results of the landlord's mitigation efforts and thus the extent of the prospective damages which inferentially will be offset against the "advance

---

could be paid from counsel's retainer, as to which it had a valid retaining lien under state law), *vacated on other grounds*, 195 F.3d 1053 (9th Cir. 1999).

[26] A duty the bankruptcy trustee may enforce. *See* 11 U.S.C. § 542(a) (West 2001).

[27] The statute even provides for the imposition of a statutory penalty for the landlord's "bad faith retention" of a security deposit beyond the deadline. Cal. Civ. Code § 1950.7(f) (West 2001).

payment". If the funds in question constitute an "advance payment", the landlord could argue, the statute impliedly authorizes their retention and application against prospective damages.

There are two fundamental flaws in this argument. First, the statute specifically defines the term "security deposit" to include an "advance payment of rent"[28], and equally expressly commands that any security deposit be returned, net of retrospective damages, promptly after the surrender of the premises.[29] Ordinary rules of statutory construction do not permit the clear dictate of the statute to be overcome by an inference from a notice statute.[30]

Second, the legislative history indicates that the "advance payment" statute was *not* intended to alter the law regarding security deposits. Specifically, the Law Revision Commission Comment respecting the section states:

> Section 1951.7 does not in any way affect the right of the lessor to recover damages nor the right of a lessee to recover prepaid rent, a security deposit, or other payment. The section is included merely to provide a means whereby the lessee whose lease has been terminated under section 1951.2 may obtain information concerning the length of the term of the new lease and the rent provided in the new lease.

Thus, while an argument based on section 1951.7 can be made, it is a weak one and should not be expected to prevail. In the face of unequivocal statutory language, supported by the only appellate court decision on the subject, it should be expected that the landlord will be required to surrender the security deposit to the bankruptcy trustee.

---

28 Cal. Civ. Code § 1950.7(a) (West 2001).

29 Cal. Civ. Code § 1950.7(c) (West 2001).

30 Especially where a reasonable alternative interpretation is available: a tenant who meets the qualifications of section 1951.7 is likely to be able to respond to a judgment for prospective damages and hence will want an easy mechanism to obtain information about his prospective liability, regardless of whether that liability will be satisfied from his "advance payment" or his assets generally.

Draft Arounds:

Any lawyer's natural reaction would be to try to draft around the statute. Since the unfortunate consequences are driven by characterizing the funds in question as a "security deposit," an obvious first step would be to attach a different label to the funds. For example, one might describe the funds as "collateral" to secure performance of all lease obligations.

"Re-naming" the deposit is certainly necessary[31], but alone it will not solve the problem. Section 1950.7(a) attempts to override terminology by providing that all funds tendered to the landlord, regardless of the label attached to them, will be treated as "security deposits" if their purpose is to secure performance of the lease[32]. Thus, any deposit provided at the commencement of a lease to assure performance will constitute a "security deposit."

The statute, however, defines "security deposit" as constituting a "payment or deposit of money". A good argument can be made, therefore, that if something other than "money" is tendered to secure performance of a lease – a letter of credit, for example – it does not fall within the definition of "security deposit" and hence avoids the foregoing problem.[33]

Finally, the greater the distance between a traditional "security deposit" and the transaction, the greater the likelihood that the funds in question will be treated as something other than a "security deposit". For example, a security deposit is ordinarily tendered by the tenant; if funds are tendered by, e.g., a subsidiary to secure its guarantee of the lease, will that escape characterization as

---

[31] If the funds in question are termed a "security deposit" under the lease, it will be assumed that the landlord used statutory language intentionally, and that the parties chose to be subject to section 1950.7. The lease must use a different phrase if the landlord hopes to escape the consequences of section 1950.7.

[32] California Civil Code section 1950.7(a) provides:

> (a) Any payment or deposit of money the primary function of which is to secure the performance of a rental agreement for other than residential property or any part of the agreement, other than a payment or deposit, including an advance payment of rent, made to secure the execution of a rental agreement, shall be governed by the provisions of this section.

[33] Unless, as is often the case, the lease defines the letter of credit as an "additional security deposit."

a "security deposit" under the statute?

While there is no clear and certain escape from the problem discussed in this article, a landlord can and should do three things to minimize its exposure. First, it should avoid the phrase "security deposit" and use, instead, phrases like "cash collateral." Second, it should look to letters of credit and other collateral which will not be seen as "deposits of money". Finally, it should consider adopting structures which are at a substantial distance from the traditional security deposits – such as secured affiliate guaranties – so that the transaction will be accepted as structured, instead of being "deemed to be" a security deposit pursuant to the statute.

IV. Conclusion

There is no clear and certain solution to the problem, in part because the relevant statute is designed to prevent "draft arounds." On the other hand, there appears to be no real policy justification for an expansive interpretation of the statute and so, with appropriately careful drafting, a landlord may hope to keep its security deposit, despite the tenant's bankruptcy filing.