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Gone with the Wind

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September 2005

Gone with the Wind

Roger Bernhardt

A combination of recent decisions dealing with abandoning commercial tenants offers a nice opportunity to review what landlords can and can't do when confronted with that situation.

CC §1951.2: Damages and Reentry

Lu v Grewal (2005) 130 CA4th 841, 30 CR3d 623, reported at p 134, makes the statutory benefit of the bargain damage recovery against an abandoning tenant *not* subject to any reduction because of the personal business profit made by the landlord when she took over the premises and turned the business around after her tenant left. (For consistency, I'll refer to all landlords as "she" and all tenants as "he.")

Under CC §1951.2, the lease ended when the tenant abandoned and the time stated in the landlord's notice to quit expired (the special rent remedy of CC §1951.4 was not invoked); this established the landlord's recovery as the difference between the rent reserved under the lease and the rental value of the premises for the remainder of the term. (So, if the rent reserved under the lease was \$5000 a month, but the rental value of the premises was only \$4000 a month at the time of abandonment, the landlord is entitled to a rental loss of \$1000—5000 less 4000—times the number of months left under the lease, adjusted upward for interest on months prior to trial and discounted for future value on the months left after trial, until the termination date of the lease.)

This formula puts a *de facto* duty to mitigate on the landlord, since if her tenant is going to be credited for what she could have relet the premises, it is too dangerous not to try to get that much money herself from a replacement tenant. At the same time, the burden of proving all this is on the tenant, who also has the *de facto* opportunity to mitigate his liability by finding and proffering a ready and willing replacement (whom the landlord rejects at her peril).

When the mitigating party is the landlord herself—*i.e.*, when, as here, she reenters the premises and runs the business—the above formula should not change. A court still first determines the rental value of the premises, *i.e.*, how much rent the landlord should be paying to herself, and then deducts that amount from the rent the abandoning tenant was supposed to pay. Whether her business was profitable says nothing about the rental value of the premises where it was conducted. Thus, the "operational profits" and "sale valuation" used by the experts in this trial were out of place and should never have been admitted into evidence.

In general, the landlord's retaking possession does make determination of rental value less subject to the landlord's control. On the other hand, if the landlord believes that she has no real choice but to go back herself, she might be better off in creating a new entity and executing the new lease with it, on terms that, while favorable, are not so far out of line as to be rejected out of hand. (If the old tenant wants to match or beat those terms with his own candidate, all the better.)

The Security Deposit and the Bankruptcy Cap

Landlords have had enough experience with defaulting tenants to know they need front-end protection, which they obtain by requiring security deposits at the start. During the dot.com boom, it was common to see landlords taking letters of credit—covering from 6 to 18 months of rent—posted by tenants’ lenders or investors. (Letters of credit were popular with tenants because they didn’t require real money, and were attractive to landlords because the independence principle made them supposedly more invulnerable to attachment than plain cash.)

But *AMB Prop., L.P. v Official Creditors for the Estate of AB Liquidating Corp.* (*In re AB Liquidating Corp.*) (9th Cir 2005) 416 F3d 961, reported at p 133, shows that the existence of a security deposit does not necessarily provide as much protection as the landlord would like when her tenant goes under. If he files bankruptcy, her recovery is capped by 11 USC §502(b)(6) at one year’s rent (in most cases). In this case, that cap limited the landlord’s allowed claim to \$2 million, even though she incurred damages of \$5 million. Worse, the \$1 million security deposit she held was not applied just against her gross \$5 million claim (reducing it to \$4 million), but was applied against the \$2 million capped claim. Thus, her remaining allowed claim was only \$1 million. She could keep the security deposit, but her allowed remaining claim was only \$1 million beyond that. That may not be the result §502(b)(6) literally commands, but it is how the section has been read by other courts and accepted by the Congress, and thus is now the rule in the Ninth Circuit.

(There is a small chance that a security deposit consisting of a letter of credit *not* collateralized by the debtor’s property might be treated differently, but how many issuers of such letters would be willing to do so without full collateral?)

Under this formula, risk-averse landlords would be advised to seek security deposits equal to a full year’s rent, not just six months, if they can get them. (An even larger security deposit might look nicer, but it would not do much better, because the excess over the capped claim—the one year’s rent—would probably just have to be turned over to the bankruptcy trustee.)

The Security Deposit and CC §1950.7

250 L.L.C. v PhotoPoint Corp. (2005) 131 CA4th 703, CR3d, 32 CR3d 292, reported at p 133, poses an even greater threat to a landlord’s retention of the security deposit. *PhotoPoint’s* holding puts the mandate of CC §1950.7—that a landlord return the unused part of a security deposit within two weeks of retaking possession—in front of most other rules and defenses she may have, even when her damages exceed the security deposit she holds. (I admit to some bias in this case, having been involved in it.)

There is an obvious incompatibility between a security deposit that is set at the next 18 months of rent and the statutory requirement that all of it except “defaults in the payment of rent” be returned to the tenant within two weeks of the lease termination. This case rejected the landlord’s contention that those rent defaults included her CC §1951.2 statutory damages on the ground that this was not a calculation a landlord can make by herself after the tenant’s departure; she can retain the deposit only to cover any unpaid back rent, but not her future benefit of the bargain loss. Economically, that means that when a tenant defaults and skips, leaving the landlord with vacant premises and no replacement prospect, the landlord is nevertheless required (by §1950.7) to return the security deposit and separately pursue in court her damages (under §1951.2) although they arose at the same time.

There are three possible counters for the landlord to consider in trying to avoid this catastrophe. Based on this opinion, they have varying degrees of possible success.

- First would be for the landlord to acknowledge the force of the security deposit statute (§1950.7), admit she violated it by not returning the funds within two weeks, but maintain her right to hold the funds as a legitimate *setoff* (against the tenant’s statutory claim for return). After all, CCP §431.70 provides that a demand for money (§1951.2 damages) may be asserted as a defense to a cross-demand for money (for a §1950.7 refund) because each one compensates the other, as the supreme court’s decision in *Granberry v Islay Invs.* (1995) 9 C4th 738, 38 CR2d 650, seems to have held in a residential landlord-tenant context. The trouble with this strategy is that this court considered and rejected it, confining the *Granberry* holding to claims that were already matured, and treating the landlord’s attempt to hold more as attempting to “profit from his own wrong.” While such characterization may be a little strong under these facts (the trial court found that the landlord was damaged by the tenant’s breach in the amount of \$1.6 million as against the withheld security deposit of \$890,000), nevertheless, the holding does make reliance on general setoff law unhelpful. Maybe some alternative strategy—such as interpleader or cross-complaint—would make a difference, but it is doubtful.
- Second would be for the landlord to try to rely on CC §1951.4 rather than §1951.2 as the basis for holding on to the deposit. The lease in *PhotoPoint* ended because the landlord terminated the lease and proceeded under §1951.2. Many leases provide the alternative remedy of suing for the rent as it falls due, without terminating the lease, so that this landlord might have sought to postpone her duty to refund by keeping the lease in force as long as possible. That strategy may run into the practical problem of the letter of credit itself expiring before it can be fully drawn down, unless at the last moment the remainder can be converted into cash and still held as a deposit. It also runs into the more complicated legal question of whether a landlord can still keep the lease alive (and hold on to the security deposit) if her tenant has filed bankruptcy and the trustee has rejected the unexpired lease under §365 of the Bankruptcy Code. Under those circumstances, the deposit may still be subject to the bankruptcy cap, but the landlord might be treated as a secured rather than general creditor with regard to it, as long as lease rejection in bankruptcy is not equal to lease termination under nonbankruptcy law. In any event, §1951.4, even with its uncertainties, seems a safer haven for a landlord trying to hold onto the security deposit than does §1951.2, although it does force her to defer pocketing the money all at once.
- The third, and probably least risky, strategy would be to make the tenant waive its rights under §1950.7. The *PhotoPoint* decision says that such a waiver is allowable, but was not done properly in that case. The obvious language would be something like “Tenant hereby waives all of its rights under Civil Code §1950.7,” but given the obvious hostility of courts to such waivers by tenants, don’t expect me to guarantee.