



# California Leasing Issues

## Don't be Caught by Surprise

By Leslie D. Reed, Pircher, Nichols & Meeks

Out-of-state landlords holding properties around the country often cling to their (or their broker's or out-of-state attorney's) "tried and true" lease forms—forms which in reality haven't been tried at all here in California. Regrettably, working without local counsel supervision of such forms (or without a well-vetted addendum to handle California issues) may prove to have unpleasantly surprising results. A number of aspects of a typical lease, from the application of security deposits to various remedies, must be attended to differently in California than elsewhere. One good practice is to have handy an addendum of California-specific provisions written from the landlord's perspective that can be utilized alongside (or pulled from to supplement) a familiar—but technically deficient—existing form lease. Of course, the importance of seeking local counsel experienced in these matters to help avoid unanticipated "gotcha" situations cannot be overemphasized. This article will highlight a number of (but by no means all of) these items for the unfamiliar landlord or practitioner.

### Security Deposit Application

First, California's Civil Code (the "Code") delineates the permissible default applications by landlord of a security deposit in the commercial context, and prescribes the timeframes for such application, as well as the subsequent return of any excess amounts to tenant.<sup>1</sup> California courts have interpreted Section 1950.7 to allow a security deposit to be applied only to the payment of "unpaid rent accrued as of the date called for in the statute for the return of the deposit," to the repair of any tenant-caused damage to the premises, or to the cleaning of the premises at the time of termination.<sup>2</sup> Absent a waiver of tenant's rights under the Code (which the courts have stated the parties are free to negotiate)<sup>3</sup>, and language specifying landlord's preferred applications and timeframes for application and return of any excess amounts, the unwitting landlord may find itself unable to utilize the security deposit in the manner it is accustomed to do elsewhere. For instance, without such waiver, the security deposit may not be used to offset unpaid

future rent, or other amounts landlord would undoubtedly consider damages as a result of tenant's breach. However, where a form lease remains silent on this issue, the Code will prevent such offset.

### Statutory Termination Rights of Tenant

A second very important landlord's issue is that of tenant's termination rights. Lenders have always been traditionally leery of termination rights, even when financing was far more readily available than it is at this time. In the current economy, no landlord wants inadvertently to provide a tenant with the excuse to get out of its lease. Two examples to look out for appear below.

First, in California, the Code creates a termination right in favor of tenant if a landlord does not put the premises into good repair within a reasonable amount of time following a request to do so.<sup>4</sup> Leaving the lease silent on this topic inadvertently provides tenant an unanticipated (and more importantly, unbargained-for) way out of that lease. To avoid this surprise, the drafter must provide for tenant to accept the premises in as-is condition and to waive its rights under this statute. Of course, the as-is and waiver provisions are not intended to circumvent any bargained-for tenant improvement allowance or work agreements made in the lease, and the landlord should expect that a savvy tenant will want to see such items carved out of the waiver language before it agrees.

Another termination right lurks in the Code. In the absence of an agreement of the parties to the contrary, Sections 1932(2) and 1933(4) of the Code provide that the hirer of a thing has a termination right if that thing is destroyed. Leases should therefore include a waiver of these two Code sections to avoid providing the tenant another unexpected way out of the lease in the event of a casualty; further, leases should additionally specify which party does have termination rights in the event of various types of casualty. With respect to condemnation, Section 1265.130 of the California Code of Civil Procedure (the "CP Code") similarly provides a right to tenant to petition for termination of the lease in the event that the portion taken is essential to tenant's use, or if the remaining portion

is unsuitable for tenant's use. Moreover, Sections 1265.110-1265.160 of the CP Code constitute default provisions that are incorporated into a lease absent a governing lease clause. Landlords would be wiser to ask their tenants to waive Section 1265.130, and to craft their own specific agreement with the tenant governing condemnation events, than to remain silent on the point and become subject by default to California's statutory framework.

### Catch-All Phrases That Don't Catch Everything

A third area of concern is the way in which certain broadly written provisions have been construed in California in connection with repairs and with use provisions, to name just two. With respect to repairs, a landlord should always have the tenant waive the provisions of Sections 1941 and 1942 of the Code, which otherwise award the tenant self-help rights to repair problems and to bill landlord for the costs. Frequently, however, when assigning responsibility for repairs among the parties, form leases utilize a catch-all sentence allocating "all repairs" to tenant. Yet a look at California's tenant-friendly case law reveals that a form lease obliging tenant to pay for "all" repairs under the lease may not succeed in causing that result. Indeed, two simultaneously decided cases<sup>5</sup> have resulted in the application by California courts of a six point test to determine which party must actually have been expected to pay for certain repairs, even when the parties' lease expressly states "all repairs" are tenant's responsibility. Elements of the test include evaluating the cost of the repair against the rent under the lease, the length of the lease, the nature of the repair (structural or non-structural), how likely it was that the parties actually anticipated the repair where government-mandated, etc. In those cases, the courts decided that landlord bore responsibility for the repairs because the lease was too short and the costs too high in comparison to the rent reserved under the lease, along with the other factors of the test. Consequently, in a California lease, the careful attorney or landlord will include additional specifics where significant repairs, particularly governmentally required repairs, are truly intended to be tenant's

<sup>1</sup> California Civil Code § 1950.7.

<sup>2</sup> See *250 LLC v. Photopoint Corp. (USA)*, (2005) 32 Cal.Rptr.3d 296.

<sup>3</sup> *Id.*

<sup>4</sup> California Civil Code § 1932(1).

<sup>5</sup> *Brown v. Green* (1994) 8 Cal. 4<sup>th</sup> 812 and *Hudlin v. Schwartz* (1994) 8 Cal. 4<sup>th</sup> 836.

responsibility. Moreover, the landlord or its attorney will also want to expressly negate the relevance of any of the factors listed in the cases that are, in fact, not part of the deal.

Another dangerous catch-all relates to use provisions. Landlords who would like tight control of the uses of the premises should consider providing specifically for the exclusion of any uses not set forth particularly in the lease. If instead the landlord, attempting to preserve flexibility in handling unforeseen circumstances, uses language affording tenant only the uses "to which landlord consents," it must be careful to also provide for its desired standard of consent, or be limited by default in California to a reasonableness standard by the Code (for any leases executed after January 1, 1992). Put another way, if the intent is, for instance, to subject assignment and subletting to landlord's reasonable approval rights, but to limit the uses to that (or those) specified under the lease (with any change in use subject to landlord's sole and absolute discretion even if the change is in connection with an assignment or sublease), that needs to be specified.

#### **Continuing Lease After Breach and Assignment Right**

Turning to breaches and remedies, one typical example of a remedy landlords prefer to include in their leases is that provided under Section 1951.4 of the Code, permitting a landlord to continue the lease in effect following a breach and to collect rent as it becomes due. Yet, in California, such remedy is only available to a landlord if (1) it is expressly included in the lease, and (2) tenant also has the right to assign and sublet under the lease (subject to the landlord's reasonable consent or to express standards of consent that are set forth in the lease). Accordingly, landlords who elsewhere prefer to restrict assignment and subletting by prohibiting it altogether, or by permitting it only subject to landlord's sole and absolute discretion, must weigh the impact of these restrictions on their ability to utilize this particular remedy in California.

#### **Unlawful Detainer and Unexpected Landlord Liability**

For landlords who instead choose to evict, default by tenant now creates a brand new risk. Just recently, California courts dramatically expanded a commercial landlord's duty of care to third parties (and consequently, its potential liability) as a result of its eviction of a tenant. *Stone v. Center Trust Retail Properties, Inc.*, (2008) 163 Cal.App. 4th 608, created a new bright line standard: upon entry of a judgment for possession in an unlawful detainer action, a landlord's duty of care to third parties now includes inspecting its premises for unsafe conditions and making reasonable periodic inspections thereafter. If

the landlord fails to do so, it can be held liable to a third party injured on the premises—in the *Stone* case, to the tune of a six-figure judgment—even where landlord doesn't yet have actual possession of the premises, and even for a condition it knows nothing about. The court reasoned that an action for eviction "unsettled" the landlord-tenant relationship (which typically protects landlord by vesting the duty of care in tenant following tenant's possession), that entry of a judgment for possession reduced any incentive tenant has to maintain the property, and that the landlord takes on a "hybrid status" following such entry of judgment that essentially shifts the duty of care back to landlord. Consequently, the court held that the landlord had both the duty and the right to inspect the property, and that such duty attached as of the time of the entry of judgment of possession in its unlawful detainer action, not after it had taken actual possession. Note that in *Stone*, the third party was injured *less than two weeks following the entry of judgment*, during the short period the tenant restaurant continued to operate. As a result, landlords now need to take quick action when they pursue and win unlawful detainer actions. Drafters need to ensure that their California forms provide landlord the right to enter and inspect upon default. Landlords (or their property managers), in turn, must be prepared to inspect properties immediately (and to repair dangerous conditions such inspections reveal), and they should not delay obtaining a writ of possession permitting the physical dispossession of tenant by the sheriff as soon as practicable.

#### **Redemption Right in Tenant**

For tenants who have been dispossessed following a breach, Section 3275 of California's Code and Sections 473, 1174 and 1179 of the CP Code provide protections in the form of a right of redemption of tenant's leasehold interest. Thus, most landlords will want their tenants to waive and release their rights under all of these statutes. In negotiating for this waiver, note that the redemption right is subject to a judge's discretion; hence, savvy tenants will resist a waiver, arguing that they should not be subject to the disproportionate risk of dispossession as the consequence of losing a good faith dispute with the landlord in court (say, over who should have repaired a damaged roof or other item not clearly allocated in the lease), and that such an onerous risk acts unacceptably to preclude them from pursuing sincere, good faith disputes.

#### **Default Notices**

When a default does arise, the CP Code further protects tenants by insisting upon very strict notice requirements contained in Sections 1161 and 1162, the latter of which governs the notices required under the

former. A California lease should provide that when a landlord gives a tenant notice in accordance with the default provisions of the lease, such notice is in lieu of, and not in addition to, the statutory notice required by Section 1161, and that such notice expressly replaces and satisfies the requirements of Section 1162. Of course, the notice should then in fact be carefully drafted in accordance with the statutory requirements.

#### **Mechanics Liens/Notices of Completion**

Finally, landlords will want to avoid mechanics' lien issues for alterations, improvements, additions or changes to the premises. Their leases should therefore require the tenant to provide landlord with notification when any such work will be done on the premises. Landlord should also insist on the right in the lease to post a Notice of Non-Responsibility at the premises upon obtaining knowledge of the commencement of such activity, as well as to record the same, in accordance with Section 3094 of the Code. Similarly, landlords should also insist that, upon the completion of any such work, tenant must cause the recording of a Notice of Completion in accordance with Section 3093 of the Code (and to provide a conformed copy to landlord).

However, note that where an owner "orders" or "causes" the improvements (such as, for example, by "requiring" such improvements of the tenant in the lease itself), a Notice of Non-Responsibility may not be valid. Where landlord intends to require such improvements, it should consider the above risks carefully, and may need to take additional precautions prior to the work beginning in order to maximize its chance of protecting itself from such claims.<sup>6</sup>

#### **Conclusion**

The above is a small sampling of the mistakes counsel, brokers and landlords unwittingly make when choosing a form that has not been appropriately vetted or tailored to protect the landlord from California's statutory framework. Additional pitfalls await the unwary landlord or attorney who is unfamiliar with California leasing law but relies on a "one-size-fits-all" form just the same. The wise landlord will ensure that its documents are vetted by experienced California counsel (or, for that matter, local counsel for any state wherein its premises are located), and will either tailor its forms with appropriate modifications, or obtain and integrate a superseding addendum that provides the desired protections a form lease, by its nature, is unlikely to contain. **CC**

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<sup>6</sup> See Alan S. Perlak and Leslie D. Reed, *Mechanics' Liens: Don't Be Caught By Surprise*, California Centers, Number 67, April 2006.

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