



Digital Commons@

Loyola Marymount University
LMU Loyola Law School

Loyola of Los Angeles Law Review

Volume 12 | Number 1

Article 3

12-1-1978

Tenant Front End Payments

William G. Coskran

Follow this and additional works at: <https://digitalcommons.lmu.edu/llr>



Part of the [Law Commons](#)

Recommended Citation

William G. Coskran, *Tenant Front End Payments*, 12 Loy. L.A. L. Rev. 37 (1978).

Available at: <https://digitalcommons.lmu.edu/llr/vol12/iss1/3>

This Article is brought to you for free and open access by the Law Reviews at Digital Commons @ Loyola Marymount University and Loyola Law School. It has been accepted for inclusion in Loyola of Los Angeles Law Review by an authorized administrator of Digital Commons@Loyola Marymount University and Loyola Law School. For more information, please contact digitalcommons@lmu.edu.

TENANT FRONT END PAYMENTS

by William G. Coskran*

CONTENTS

I. INTRODUCTION.....	38
II. TYPES OF FRONT END PAYMENTS.....	38
III. REFUND OF OR OFFSET AGAINST FRONT END PAY- MENTS	39
A. <i>Case Law Absent Statute Application</i>	40
1. Security Deposit	40
2. Liquidated Damages—Background	40
3. Advance Payment of Rent, Bonus or Consideration for Execution	42
a. <i>No Fault Termination</i>	43
b. <i>Lessor Fault Termination</i>	44
c. <i>Construction and Drafting Problems—Tenant's Cases</i>	45
d. <i>Construction and Drafting Problems—Lessor's Cases</i>	49
e. <i>Construction and Drafting Problems—Conclusion</i>	52
4. Option Payment—To Lease or Terminate	53
5. Summary and Comment	55
B. <i>Statutory Provisions</i>	60
1. Type of Tenancy	60
2. Applicability Date	61
3. Types of Front End Payments Covered	62
4. Maximum Amount	66
5. Amounts Lessor Can Claim from Deposit	67
6. Refund Time Limit and Penalty	69
7. Priority of Tenant's Claim	69
8. Accounting	70
9. Relief from Liability when Lessor Transfers	71
10. Waiver by Tenant	72

* B.S., 1957 (Loyola University); J.D., 1959 (Loyola Law School). Professor of Law, Loyola Law School, Los Angeles.

C. <i>Transfer of Lessor's or Tenant's Interest in the Property</i>	74
IV. LIQUIDATED DAMAGES	75
A. <i>Nature</i>	75
B. <i>Pre-July 1, 1978 Clauses</i>	76
C. <i>Post-July 1, 1978 Clauses</i>	77
V. OTHER FACTORS	82
A. <i>Income Tax Treatment</i>	82
B. <i>Deed of Trust Sale or Foreclosure</i>	83
VI. CONCLUSION	84

I. INTRODUCTION

Almost all leasing transactions, whether residential or commercial, involve a payment of a lump sum by the Tenant to the Lessor before the tenancy begins. Most of the time, the Lessor's position is expressed in the general thought: "I want some money up front." This general thought is typically the product of one or more of the following motivations or purposes for a front end payment:

1. Consideration for something given or to be given by the Lessor.
2. Security for the Tenant's future performance.
3. Induce performance and deter breach (the "be a good scout" motive).

At first glance, dealing with front end payments may appear to be as easy as pouring sand out of a boot with instructions on the heel. However, there are several ways in which the front end payment can be structured, and the ramifications of the particular choice can have a significant impact on the parties. Sometimes the choice is made without an appreciation of the distinctions. Other times, even if the distinctions are recognized, the effect of the choice may be unclear or have a deceptive appearance of clarity.

The purpose of this article is to categorize the various types of front end payments in California, analyze their ramifications, identify problem areas and propose solutions. The scope includes all Lessor/Tenant relationships, whether commercial or residential, and whether fixed term or month to month.

II. TYPES OF FRONT END PAYMENTS

The three principal types of front end payments are: (1) advance payment of rent; (2) bonus or consideration for execution of lease; and (3) security deposit. Two other common types also fall in the general category of front end payments: (1) liquidated damages; and (2) option payment.

An *advance payment of rent* is a prepayment of rent for a future period. Although rent for the first month is typically prepaid at the time the lease is executed, and rent for successive months is due in advance, the advance payments of rent dealt with in this article refer only to prepayments for the last one or more months of the term.

A *bonus or consideration for execution* of lease is ostensibly a payment to the Lessor in exchange for his entering into the lease. This should be distinguished from an option payment, mentioned below.

A *security deposit* is a sum put in the Lessor's hands to hold for use in the event the Tenant defaults in performing his obligations under the tenancy, such as failure to pay rent, failure to clean or causing damages to the premises.

A *liquidated damage deposit* is a variation of the security deposit. The parties provide that a specific amount (or an amount determinable by a specific formula) is the agreed amount of damages in the event of particular breaches by the Tenant.

An *option payment* is the consideration given by a prospective Tenant to a prospective Lessor for an option to lease in the future on certain agreed terms. It can also be consideration for an option to terminate the lease and be excused from further obligations.

III. REFUND OF OR OFFSET AGAINST FRONT END PAYMENTS

A question that frequently arises between the disillusioned parties to a delicate relationship gone sour is: Can the Lessor keep the front end payment even though it exceeds actual damages suffered by, or amounts due to, the Lessor? There is also a related question: Can the Tenant offset the front end payment against damages or amounts due to the Lessor?

For example, suppose:

Front End Payment	\$1,000
Delinquent Rent and Damages	\$ <u>700</u>
	\$ 300

Can the Lessor keep the \$300 or must it be refunded?

Can the Tenant offset \$700 of the front end payment against the delinquent rent and damages, or can the Lessor keep the \$1,000 and sue for an additional \$700?

The simple answer to these questions is: It depends!

Although legislation dealing with the problem is now on the books, there are sufficient gaps and ambiguities to provide for some suspense and research. In order to understand which front end payments the

statutes cover and how to deal with those payments not covered, it is helpful to review the California case law that preceded the statutes. Following that, there will be a review of the original statute enacted in 1970 and the statutory changes enacted in 1977. Statutory and case law dealing with liquidated damages will be treated separately.

A. Case Law Absent Statute Application

Prior to the enactment of Civil Code section 1950.5¹ in 1970 and the amendment of that section² and addition of Civil Code section 1950.7³ in 1977, the California courts developed rules that based the availability of refund of a front end payment and the use of such a payment to offset amounts due the Lessor on the type of front end payment involved. A distinction based on labels creates a situation in which it does not matter what you pay (or receive) as long as you pronounce it correctly.

1. Security Deposit

If a payment is determined to be a security deposit, it is to be credited toward amounts due the Lessor and any excess must be refunded to the Tenant.⁴ The purpose of such a payment is to provide the Lessor with a fund as security for the Tenant's performance and it can be used only to cover delinquent rents or other amounts due or damages owed to the Lessor.

2. Liquidated Damages—Background

Attempts by Lessors to sweeten their positions by inserting provisions allowing them to keep the entire deposit if the Tenant breaches, without considering the actual amount of damages, have consistently turned sour. The courts have declared such provisions to be void as a penalty and an attempt to fix damages in anticipation of breach in vio-

1. Act of Sept. 17, 1970, ch. 1317, § 1, 1970 Stat. 2452 (current version at CAL. CIV. CODE § 1950.5 (West Supp. 1978)) (note that statute was originally misnumbered § 1951).

2. CAL. CIV. CODE § 1950.5 (West Supp. 1978).

3. *Id.* § 1950.7.

4. Although "string citations" in law review articles are frowned upon, the brow must suffer a few such furrows in this article. One of the purposes of section III.A. is to provide practitioners with a single source of significant cases dealing with the topic footnoted. *Redmon v. Graham*, 211 Cal. 491, 295 P. 1031 (1931); *Boral v. Caldwell*, 223 Cal. App. 2d 157, 35 Cal. Rptr. 689 (1963); *Warming v. Shapiro*, 118 Cal. App. 2d 72, 257 P.2d 74 (1953); *Garfinkle v. Montgomery*, 113 Cal. App. 2d 149, 248 P.2d 52 (1952); *Ace Realty Co. v. Friedman*, 106 Cal. App. 2d 805, 236 P.2d 174 (1951); *Thompson v. Swiryn*, 95 Cal. App. 2d 619, 213 P.2d 740 (1950).

lation of former Civil Code section 1670.⁵ The major requirement for valid liquidated damages, set forth in Civil Code section 1671, has been that "from the nature of the case, it would be impracticable or extremely difficult to fix the actual damage."⁶ Most cases have held that this requirement has not been met.⁷

Since the deposit is in essence a security deposit, the Lessor can generally still apply it to actual amounts due to him, even though the forfeiture provision is void—*i.e.*, no bonus, but no loss. However, the case of *Green v. Frahm*⁸ presents a potential trap for the Lessor who puts all his eggs in the liquidated damage basket. In that case the Tenant made a front end payment of \$3,000, under a lease which provided that it was to be retained by the Lessor as a "guarantee" that the Tenant would pay his rent and perform the lease covenants. If the Tenant defaulted, the \$3,000 was to be "forfeited" to Lessor. If the Tenant performed, the payment would bear interest and be returned to Tenant at the end of the term or upon premature termination without fault of the Tenant. The lease was terminated for rent default. In an unlawful detainer action, the Lessor recovered possession and a judgment for \$500 rent. The former Tenant then assigned his claim to the \$3,000 to Green. In the action by Green against the Lessor, the court held the provision for forfeiture to be void as a penalty and in violation of Civil Code section 1670. The court concluded that since the Lessor had taken the position that the whole sum had been forfeited and did not ask that a portion of the deposit be applied to the delinquent rent, plaintiff was entitled to recover the entire \$3,000. The Lessor's conduct was deemed to be a repudiation of the security deposit and a waiver of his right to retain any portion for the rent due. This left the Lessor to attempt to collect the delinquent rent judgment from his former Tenant.

Although the early cases seem to shut the door on valid liquidated damage provisions in leases, there are certain types of damages flowing from a Tenant's breach that should now be subject to valid liquidation. This conclusion is based on three factors: (1) the repeal of Civil Code

5. Civil Code of 1872, § 1670 (current version at CAL. CIV. CODE § 1671(d) (West Supp. 1978)). See *Redmon v. Graham*, 211 Cal. 491, 295 P. 1031 (1931); *Knight v. Marks*, 183 Cal. 354, 191 P. 531 (1920); *Green v. Frahm*, 176 Cal. 259, 168 P. 114 (1917); *Jack v. Sinsheimer*, 125 Cal. 563, 58 P. 130 (1899); *Parish v. Studebaker*, 50 Cal. App. 719, 195 P. 721 (1920); *Rez v. Summers*, 34 Cal. App. 527, 168 P. 156 (1917).

6. Civil Code of 1872, § 1670 (current version at CAL. CIV. CODE § 1671 (West Supp. 1978)) (note that amendment became operative July 1, 1978).

7. *Knight v. Marks*, 183 Cal. 354, 191 P. 531 (1920); *Jack v. Sinsheimer*, 125 Cal. 563, 58 P. 130 (1899); *Parish v. Studebaker*, 50 Cal. App. 719, 195 P. 721 (1920); *Rez v. Summers*, 34 Cal. App. 527, 168 P. 156 (1917).

8. *Green v. Frahm*, 176 Cal. 259, 168 P. 114 (1917).

section 1670 and the amendment of Civil Code section 1671, operative July 1, 1978; (2) the range of Lessor remedies and damages provided in Civil Code sections 1951.2 and 1951.4,⁹ operative July 1, 1971; and (3) the facts of the cases that produced the broad statements of invalidity of liquidated damages in leases. The availability of liquidated damages will be given separate treatment below.

3. Advance Payment of Rent, Bonus or Consideration for Execution

Now the good news for the Lessor. As long as the front end payment is clearly given as an advance payment of rent or as a bonus or consideration for Lessor's execution of the lease, the cases have consistently held that the Lessor may keep the entire payment. Also, it need not be offset against amounts due to the Lessor from the Tenant.¹⁰ These payments have been treated as belonging absolutely to the Lessor from the moment of payment, with title to the fund passing immediately upon payment.

Although with respect to an advance payment of rent, this result might be thought to be an application of the common law rule that rent for a certain period accrues on its due date and is not apportionable on the basis of time,¹¹ this is only partially true. The right to retain appears to depend upon actual payment to the Lessor, not merely upon accrual of the due date. For example, in *Respini v. Porta*¹² a quarterly advance payment of rent had accrued but had not yet been paid when the Tenant defaulted. The court held that Lessor was entitled to recover only his damages, not the full amount of the rent.

9. CAL. CIV. CODE §§ 1951.2, 1951.4 (West Supp. 1978).

10. *Harvey v. Weisbaum*, 159 Cal. 265, 113 P. 656 (1911); *Warming v. Shapiro*, 118 Cal. App. 2d 72, 257 P.2d 74 (1953); *Ace Realty Co. v. Friedman*, 106 Cal. App. 2d 805, 236 P.2d 174 (1951); *Parigian v. Citizens Nat'l Trust & Sav. Bank*, 42 Cal. App. 2d 773, 110 P.2d 117 (1941); *Grand Cent. Pub. Mkt. v. Kojima*, 11 Cal. App. 2d 712, 54 P.2d 786 (1936); *A-1 Garage v. Lange Inv. Co.*, 6 Cal. App. 2d 593, 44 P.2d 681 (1935); *Weinreich v. Vernon*, 109 Cal. App. 60, 292 P. 651 (1930); *Wood v. Hipwell*, 107 Cal. App. 680, 290 P. 1040 (1930); *Foye v. Simpkinson*, 89 Cal. App. 119, 264 P. 331 (1928); *Gordon v. Harris*, 94 Cal. App. 682, 271 P. 779 (1928); *Pigg v. Kelley*, 92 Cal. App. 329, 268 P. 463 (1928); *McArthur v. Kluck*, 75 Cal. App. 785, 243 P. 453 (1925); *Wetzler v. Patterson*, 73 Cal. App. 527, 238 P. 1077 (1925); *Anderson v. Julius Levin Co.*, 71 Cal. App. 73, 234 P. 442 (1925); *Curtis v. Arnold*, 43 Cal. App. 97, 184 P. 510 (1919); *Ramish v. Workman*, 33 Cal. App. 19, 164 P. 26 (1917).

11. *Fahrenbaker v. E. Clemens Horst Co.*, 209 Cal. 7, 284 P. 905 (1930); *Friedman v. Isenbruck*, 111 Cal. App. 2d 326, 244 P.2d 718 (1952).

12. 89 Cal. 464, 26 P. 967 (1891).

a. No Fault Termination

When the leasing relationship is terminated due to the Tenant's default, the Tenant might be consoled a bit by the realization that it was his own fault that he is out the money. But if the lease is terminated prematurely without fault he still recovers nothing and has no such consolation.¹³ In *Harvey v. Weisbaum*,¹⁴ the Tenant made an advance payment of rent of \$2,700 for the first year of a two-year lease. After about a month and a half, the premises were destroyed by a fire following an earthquake and the lease terminated. The Tenant was denied a refund for the portion of the rent attributable to the balance of the year. The court said the payment was final and absolute. It also noted that the destruction was unforeseen and due to no fault of either party. Thus, the court concluded each party must suffer, and since they were equally innocent, the law should not interfere to aid a Tenant who has not taken the precaution to provide for the contingency in the lease.

This seems to be tough medicine for a Tenant who paid for something he did not get, through no fault of his own. Maybe he did not provide for the "contingency" because he believed he would not have to pay for what he did not receive—a trap for the naive draftsman. The court said that the consideration for the rent paid in advance was not only the use of the premises for the future months, but also the conveyance to the Tenant by the lease and his obtaining possession of the premises. However, it does not appear from the case that the parties provided in the lease that this was the consideration for the advance payment. The parties dealt with the payment as a prepayment of rent for use of the premises for twelve months of the two-year term, and the Tenant received only one and a half months of that period. Although the court talked of the lease as a conveyance for which consideration had been paid, a lease is also an ongoing contractual relationship in which the Tenant pays for certain periods of possession to be given by the Lessor.¹⁵

It is pointed out in *Harvey* that the common law rule that destruction does not relieve the Tenant from paying rent is based on an equitable division of the loss, and a fear that the Tenant would be less careful if freed from the lease upon destruction (but keep in mind the fire here was caused by an earthquake, not by Tenant's lack of care). At common law, the impact of this rule on the Tenant could be ameliorated in

13. *C.M. Staub Shoe Co. v. Byrne*, 169 Cal. 122, 145 P. 1032 (1915); *Harvey v. Weisbaum*, 159 Cal. 265, 113 P. 656 (1911).

14. 159 Cal. 265, 113 P. 656 (1911).

15. CAL. CIV. CODE § 1925 (West 1954).

many cases where the Tenant could still put the land to some productive use for the balance of the term, because the destruction did not terminate the lease. But even this possibility is foreclosed by a termination pursuant to a lease provision or statute. California has modified the common law rule by statutes which provide for termination of a lease upon partial or total destruction, relieving a Tenant of future rent payments.¹⁶ However, the statutes do not mention relief from an advance payment of rent for the future period that the Tenant does not receive.

In the absence of careful drafting, the Tenant is in a peculiar position. Suppose a one-year lease is entered into and the premises are destroyed resulting in termination of the lease after six months. If the rent is unpaid for the final six months, it is excused. However, if the rent has been prepaid for the final six months, there is no refund. Regarding the common law rule that rent for a period accrues entirely on its due date and is not apportioned on the basis of time, California has modified the rule by statute¹⁷ to protect the Lessor, but not the Tenant. Thus, if the rent was due at the end of a period and the lease terminated before the due date, the Lessor could recover the portion of the rent attributable to the pre-termination period. But if the rent was prepaid for a period after termination, the Tenant could not get a refund. The Tenant must obtain protection by drafting for a refund of unearned rent.

If a lease is terminated by mutual consent, rather than by some event, the same result occurs.¹⁸

b. Lessor Fault Termination

A ray of sunshine brightens the Tenant's path if the lease termination is caused by the Lessor's default. In this situation, an advance payment of rent, bonus or consideration for execution is recoverable by the Tenant.¹⁹ The courts discuss the right of recovery in terms of failure of consideration and unjust enrichment.

An interesting twist on the Tenant's recovery is presented in *Butt v. Bertola*.²⁰ The monthly rent was \$100. The Tenant made a front end payment of \$600 and the lease referred to it as an absolute payment as

16. *Id.* §§ 1932(2), 1933(4).

17. *Id.* § 1935.

18. *Foye v. Simpkinson*, 89 Cal. App. 119, 264 P. 331 (1928).

19. *Friedman v. Isenbruck*, 111 Cal. App. 2d 326, 244 P.2d 718 (1952); *Butt v. Bertola*, 110 Cal. App. 2d 128, 242 P.2d 32 (1952); *Johnson v. Snyder*, 99 Cal. App. 2d 86, 221 P.2d 164 (1950); *Graham v. Wood*, 8 Cal. App. 2d 451, 48 P.2d 124 (1935).

20. 110 Cal. App. 2d 128, 242 P.2d 32 (1952).

consideration for making the lease. The lease provided that if the Tenant faithfully performed, he was to have "free rent" for the last six months of the lease. The lease was prematurely terminated by the Lessor's breach. The court said that since the Lessor deprived the Tenant of the value of the six months' free rent, the Tenant could recover that value as an item of damages. Further, the amount of damages might be more or less than the stipulated rent of \$100 per month. Thus, in this type of a situation, if there is a rising market in rental values, the Tenant may be able to recover even more than he paid to the Lessor by framing his recovery as damages rather than a refund.

c. Construction and Drafting Problems—Tenant's Cases

Is it really a security deposit, subject to refund and offset, despite language of advance payment of rent, bonus or consideration? There are several cases dealing with this question, some with the Tenant winning (discussed in this subsection) and some with the Lessor winning (discussed in the next subsection). While their results are not always clearly reconcilable on the facts, there is a consistent theme. An absolute and unconditional payment indicates an advance payment of rent, bonus or consideration for execution. If the Tenant retains some interest in the payment, it indicates a security deposit. The choice and consistency of words is crucial.

In *Rez v. Summers*,²¹ the Tenant made an \$800 front end payment and the Lessor executed a receipt stating that it was "full payment for the rent of said premises for the last two months." Standing alone, this clearly indicates an advance payment of rent. However, the lease also provided that in the event that the building could not be restored within sixty days after a destruction, "the security of eight hundred dollars is to be returned to the lessee by the lessor." The court said the payment was not absolute and unconditional because the money would be returned to the Tenant pursuant to the destruction contingency. In addition, the payment was referred to as "security."

In *Parish v. Studebaker*,²² the lease recited that Tenant had paid \$1,600 as rent for the last two months. The lease also provided that the sum would bear interest for the Tenant's benefit and that, if the lease was terminated or forfeited, the money "should become" the property of the Lessor, without affecting her right to damages. In effect, the court treated the payment as not being an absolute payment to Lessor

21. 34 Cal. App. 527, 168 P. 156 (1917).

22. 50 Cal. App. 719, 195 P. 721 (1920).

upon receipt, but rather as the Tenant's money being held by the Lessor to be applied in the future for use of the premises. The court concluded that since the Tenant's right to future possession was lost, the retention by the Lessor of the payments without offset against amounts due him would be an invalid forfeiture. Accordingly, the payment was offset against the Lessor's judgment for rent and damages. Although the recital of receipt of the payment for the last two months' rent clearly indicated an advance payment of rent, the court apparently felt that it was not an absolute and unconditional payment to the Lessor, and that the Tenant retained an interest in the funds, because of the provision for interest and the provision that upon termination the money "should become" the property of the Lessor. If it were an advance payment of rent, it would not become the property of the Lessor in the future because it would already be his upon payment. Also, if it were the property of the Lessor, it would not bear interest for the Tenant.

In *Redmon v. Graham*,²³ the lease referred to a \$5,400 payment as security for performance of the Tenant, and provided that upon the Tenant's breach the Lessor would have the right to keep it as "liquidated damages." The Lessor unsuccessfully argued that it should be considered an advance payment of rent because of a provision that it would be applied as payment of the last three months' rent if the Tenant performed. This was clearly a security deposit, and the provision concerning the last three months did not change it to an immediate advance payment of rent. It was just a provision for the future application of the Tenant's security deposit to rent. Although the court's conclusion really needed no further support, the court commented that its interpretation was strengthened by a provision that the \$5,400 would be returned upon accidental destruction. This was said to be "wholly inconsistent with the idea of an absolute payment in advance, with title to the money passing to the lessor."²⁴ The court then held the provision for retention as liquidated damages to be a void penalty in violation of Civil Code section 1670. The problem of liquidated damages will be discussed in detail later.

In *Walter H. Sullivan, Inc. v. Johnson*,²⁵ the lease provided that \$2,500 was paid to the Lessor in consideration of his leasing to the Tenant. Standing alone, this would be an absolute payment as consideration, but the lease further provided that if the Tenant performed, the

23. 211 Cal. 491, 295 P. 1031 (1931).

24. *Id.* at 494, 295 P. at 1032.

25. 116 Cal. App. 591, 3 P.2d 72 (1931).

Lessor would pay interest on the \$2,500 and credit the payment on the last five months' rent. The court treated the payment as a deposit to secure performance. It was not an absolute payment of consideration because of the provision for interest and the provision for credit against the last five months' rent. Nor was it an absolute advance payment of rent. Rather, it merely provided that it would be credited in the future for those months if the Tenant performed.

In *Bacciocco v. Curtis*,²⁶ the lease recited that "as a bonus for the lessor's execution of this lease, the lessee paid him, unconditionally upon execution thereof, the sum of five thousand dollars (\$5,000.00)." Standing alone, this would be an absolute and unconditional payment of a bonus. But the fatal seeds of security deposit were sown with provisions that if the Tenant faithfully performed, Lessor would allow interest on the \$5,000, credit it on the last five months' rent, and refund it if the lease were terminated by destruction. In addition, the Lessor gave a receipt which referred to the \$5,000 as security for the payment of rent. In upholding the trial court's finding of a security deposit, the court said the lease provisions were not easily reconcilable with the idea of an absolute transfer to the Lessor of funds in which the Tenant retained no further rights. Instead, the provisions suggested that the Tenant retained substantial rights in the fund until the end of the term.

In *Thompson v. Swiryn*,²⁷ the lease provided that the Lessor leased to the Tenant in consideration of \$9,000 (only \$6,000 was actually paid), and that the \$9,000 paid upon execution was not part of the rental. These provisions, standing alone, are clearly indicative of consideration for execution. The ten-year lease also provided for rent of \$900 per month for the first 110 months, and \$1.00 per month for the next ten months. When the Tenant sought a refund, less accrued rent, a destruction clause proved fatal to the Lessor's attempt to retain the payment without offset. This clause provided that if the Lessor elected not to restore the building after its destruction, he could terminate the lease by repayment of the fund to the Lessee, less moneys accrued to Lessor at the date of destruction. The court said it was impossible to reconcile this provision with the Lessor's contention that the money was paid as a bonus or consideration. Also, there was evidence that in the lease negotiations the payment was referred to as "security of good faith" and a "deposit" and the court said it was apparent that the payment was regarded as a deposit for security of performance, and not as consideration for the lease.

26. 12 Cal. 2d 109, 82 P.2d 385 (1938).

27. 95 Cal. App. 2d 619, 213 P.2d 740 (1950).

In *Garfinkle v. Montgomery*,²⁸ the lease provided for payment of \$1,350 upon execution, as partial security, and for payment of another \$1,350 at a later date. This was clearly a security deposit, and a provision that the \$2,700 would be applied to the rent for the final six months did not make it an advance payment of rent.

In *Dicker v. West*,²⁹ the facts demonstrate the problems of structuring an advance payment of rent when the rental is based on a percentage of the Tenant's receipts or some other variable keyed to the Tenant's use of the premises. The case involved the lease of a lumber mill for approximately two years, and the rent was based on \$3.00 per thousand board feet of lumber cut by the Tenant at the mill. The lease provided for a "deposit" of \$10,000 which "shall apply on the rental." When the lumber cut accumulated \$5,000 in rent, the Tenant was to "deposit" another \$5,000 so that the Lessor would have a "deposit" of \$10,000 "in advance on account of the rental due" on the mill. The lease terminated prematurely when a fire destroyed the mill. The Lessor's contention that he could retain the payment as an advance payment of rent was rejected. The court held that it was a fund deposited as security, out of which the rent was to be paid as it accrued. The lease also contained a provision for a minimum production that would guarantee a minimum rental. It obligated the Tenant to cut not less than 250,000 board feet per week during the logging season and, upon failure to do so, the Tenant was to pay the Lessor the difference at \$3.00 per thousand board feet. The court said this clause did not militate against its conclusion because it was merely to assure prompt performance, and the destruction of the mill made it impossible to comply.

Does *Dicker* preclude a true advance payment of rent in percentage or production rent type leases in general? It does not if the clause is structured properly. In *Dicker*, the Lessor obviously had a certain minimum amount of rent in mind when he put in the clause for minimum production. Suppose he had set up the transaction with a minimum rent of \$10,000, to be paid to the Lessor absolutely and unconditionally upon execution, with additional rent at the rate of \$3.00 per thousand board feet for lumber cut in excess of 3,333,000 board feet (\$9,999). A compulsory operation clause could be included to protect the Lessor's expectancy of additional rent. It would seem that in any percentage or production based rent lease, if a minimum rent is established and paid in whole or part in advance, the payment can be drafted into an absolute and unconditional advance payment of rent. The Lessor's problem

28. 113 Cal. App. 2d 149, 248 P.2d 52 (1952).

29. 164 Cal. App. 2d 55, 330 P.2d 106 (1958).

in the *Dicker* case was that the payment was set up as a fund to be applied in the future to rent as the lumber was cut.

In *Boral v. Caldwell*,³⁰ the Tenant of a two-year lease agreed to pay a total of \$24,000 in installments, paying \$3,000 upon execution of the lease and the remaining \$21,000 at a rate of \$1,000 per month for the second through the twenty-second months of the lease. The lease provided that if the Tenant was not in default at the end of the twenty-second month, he would be entitled to remain for an additional two months without payment of rent. Economically, it seems that the front end payment of \$3,000 was payment of the first month's rent (\$1,000) and an advance payment of rent for the last two months (\$2,000). The court said that the lease was not unambiguous. Although the word "security" was not used in the lease, the Lessor, in testimony concerning negotiations with other parties regarding a lease of the premises, had adopted the characterization by the Tenant's attorney of "security" in reference to a front end payment. The court held that the trial court's interpretation as a security deposit was not unreasonable.

The foregoing cases are examples showing that a Lessor's attempt to set up an advance payment of rent, bonus or consideration for execution, can be undermined by lease provisions, or comments made during negotiations or at trial, that indicate that the Tenant retained an interest in the payment, and that it was not an absolute and unconditional payment. The significant factors in these cases causing the courts to conclude that the payments more closely resembled security deposits than advance payments of rent or bonuses or consideration for execution can be summarized as follows:

1. Provision for refund upon destruction.
2. Provision for future application to rent.
3. Provision for interest for the benefit of the Tenant.
4. Reference to the payment as "security" or a "deposit" in the lease, a receipt, negotiations, or testimony.
5. Provision for future forfeiture, indicating a continuing interest of Tenant to be forfeited.

d. Construction and Drafting Problems—Lessor's Cases

Lest the Tenant become too flush with optimism when any of the factors mentioned above is involved, Lessors have also had some significant victories in the construction arena.

There are cases in which a provision for refund upon premature termination, such as by destruction, did not knock out the Lessor's reten-

30. 223 Cal. App. 2d 157, 35 Cal. Rptr. 689 (1963).

tion of the front end payment. In *Curtis v. Arnold*,³¹ the lease provided that "for and in consideration" of \$3,000 paid by the Tenant, the Lessor entered into the lease. If the lease terminated before the end of the ten-year term for any cause except Tenant's breach, the Lessor was to pay the Tenant \$3,000 with interest. Also, the last five months of the term were to be "free of rent" if the Tenant fully performed. The court concluded that upon default termination the Tenant was not entitled to recover any portion of the \$3,000. Title to the consideration for the Lessor's making the lease passed to the Lessor when paid. The court pointed out that even if the payment were regarded as an advance payment of rent, the Lessor was entitled to retain it (if the rent rate had been continued for the last five "free" months, it would have been \$4,625, which is approximately the same as the \$3,000 with interest for the ten-year term at the rate in the lease). Note that the court reached its conclusion despite provisions for refund and interest, and the economic effect of a credit on the last five months' rent.

In *Wood v. Hipwell*,³² a sublease provided that \$1,000 had been paid as "consideration for the making of this lease." The court treated the payment as consideration despite a provision for refund upon termination due to fire, or other casualty, and a provision that economically amounted to a credit on the rent for the last two months of the term.

In *Grand Central Public Market v. Kojima*,³³ front end payments were referred to as consideration for the Lessor's execution of leases. A provision for refund if the Lessor did not restore after destruction and a provision for credit on the last two months' rent, did not prevent the payment from being treated as an absolute payment to the Lessor. Title to the money was treated as passing to the Lessor when the leases were executed.

There are cases where the front end payments were to be credited on rent for the final months if the Tenant faithfully performed, yet the court treated the payments as belonging absolutely to the Lessor when paid. These cases involved either express provisions for credit or provisions for "free" rent where the economic realities amounted to a credit. The *Curtis*, *Wood*, and *Grand Central* cases mentioned immediately above involve this factor. Several other cases also deal with this issue. For example, in *Ramish v. Workman*,³⁴ a payment of \$7,200 "as a further consideration for this lease in addition to the rent" was treated as

31. 43 Cal. App. 97, 184 P. 510 (1919).

32. 107 Cal. App. 680, 290 P. 1040 (1930).

33. 11 Cal. App. 2d 712, 54 P.2d 786 (1936).

34. 33 Cal. App. 19, 164 P. 26 (1917).

clearly a bonus or consideration. A provision that it would be credited on the rent for the last four months and eighteen days was said to furnish no basis for a contention that the payment should be construed as a security deposit. The title to the payment passed absolutely to the Lessor unaffected by the credit provision.³⁵ In *A-1 Garage v. Lange Investment Co.*,³⁶ the court said that although a provision for refund by rent credits was an item to consider in interpreting a doubtful lease, it was not inconsistent with the expressed intent of the parties that the payment was a consideration for execution of the lease.

A provision for application of the payment to the payment of rent was combined with a provision for interest, and a reference to the payment as "security" in *Gordon v. Harris*.³⁷ This case involved a contract between a contractor and owner for the construction of a building, and a lease by the owner as Lessor to the contractor as Tenant. Instead of a front end payment passing hands from Tenant to Lessor, the lease provided that \$5,000 of the construction contract price was to be left unpaid to the contractor-Tenant "as security that the said contractor, the lessee in the lease herein, shall faithfully and substantially comply" with the lease. The lease also provided that the \$5,000 together with interest, "shall be applied" in payment of rent for the last nine months and a portion of the tenth month of the term. The court emphasized that the positive and mandatory statement that the \$5,000 plus interest "shall" be applied in payment of the rent left nothing to be applied as security for any other payments. Thus, it was held to be an advance payment of rent, not a security deposit.

A provision for future forfeiture of the payment, which arguably indicates that the Tenant has a continuing interest in the fund until it is forfeited, has been treated as not preventing an immediate and absolute payment to the Lessor. *Pigg v. Kelley*³⁸ and *Wetzler v. Patterson*³⁹ involved payments designated as advance payments of rent, with provisions that the amounts were to be forfeited to the Lessors or retained by the Lessors as a forfeiture. In both cases the courts reasoned that an advance payment of rent belonged to the Lessor from the moment of receipt and was not subject to refund anyway, so the forfeiture provi-

35. Cases to the same effect are *Warming v. Shapiro*, 118 Cal. App. 2d 72, 257 P.2d 74 (1953); *Ace Realty Co. v. Friedman*, 106 Cal. App. 2d 805, 236 P.2d 174 (1951); *A-1 Garage v. Lange Inv. Co.*, 6 Cal. App. 2d 593, 44 P.2d 681 (1935); and *Anderson v. Julius Levin Co.*, 71 Cal. App. 73, 234 P. 442 (1925).

36. 6 Cal. App. 2d 593, 44 P.2d 681 (1935).

37. 94 Cal. App. 682, 271 P. 779 (1928).

38. 92 Cal. App. 329, 268 P. 463 (1928).

39. 73 Cal. App. 527, 238 P. 1077 (1925).

sion could be ignored. Since the Tenant could not get the payment back anyway, a provision for forfeiture was just an inartful way of saying what would be the case even without the provision. The *Wetzler* court pointed out that if the payment were construed as a security deposit, the provision for forfeiture would be an illegal and void penalty and it is not to be presumed that the parties deliberately entered into an illegal contract. A similar comment about avoiding an interpretation that would render a provision void was made in *A-1 Garage v. Lange Investment Co.*,⁴⁰ discussed above. However, in *Redmon v. Graham*,⁴¹ also discussed above, the Lessor's argument that an interpretation resulting in legality should be chosen over one which leads to illegality failed. The court decided that there was no ambiguity, that the payment was a security deposit, and that the forfeiture provision was void.

The cases in this subsection are examples showing that Lessors' attempts to set up advance payments of rent, bonuses or consideration for execution may survive despite the presence of one or more of the factors that proved fatal in the cases in the preceding subsection.

e. Construction and Drafting Problems—Conclusion

Did the parties intend an absolute payment, with title passing to the Lessor upon payment (*i.e.*, an advance payment of rent, bonus or consideration for execution), or did they intend that the Tenant retain an interest in the fund (*i.e.*, a security deposit)? What you see at first glance or draft is not necessarily what you get. If the payment is labeled as an advance payment of rent, bonus or consideration, it may or may not be treated in substance as a security deposit, depending on the significance accorded other factors such as:

1. Provision for refund upon destruction.
2. Provision for future application to rent.
3. Reference to the payment as "security" or a "deposit."
4. Provision for interest for the benefit of the Tenant.
5. Provision for future forfeiture.

Unless the lease drafter enjoys the prospect of uncertain litigation, the lease provisions should be consistent with the idea that the payment is absolute, with title vested in the Lessor upon payment, or with the idea that the payment is held by the Lessor while the Tenant retains a substantial interest. The factors mentioned above are, at the very least, red flags warning of potential conflict.

40. 6 Cal. App. 2d 593, 44 P.2d 681 (1935).

41. 211 Cal. 491, 295 P. 1031 (1931).

4. Option Payment—To Lease or Terminate

If a person pays the property owner in exchange for an option to lease the property in the future, the payment belongs to the Lessor.⁴² It is consideration for the option and is independent of the mutual relationships of Lessor and Tenant that may arise between the parties if and when the option is exercised. If it is a true option, the potential Tenant has paid for and received time and the potential Lessor's obligation to lease. The potential Tenant is free to enter into the lease or not. If the lease were subsequently entered into and thereafter prematurely terminated, either due to the Tenant's fault or a no fault event such as destruction, the option payment would be retainable without offset. The payment was for a separate and independent consideration, and the Tenant received the agreed exchange.

If it is not a true option payment, but rather an attempt to disguise a payment under the lease itself, the substance and not the label should prevail. For example, generally an option is the product of a potential Tenant's desire to have the property tied up while he evaluates the decision to lease or not. Sometimes an option is a compromise solution when a potential Tenant wants certain contingencies in the lease, such as obtaining proper zoning, permits, or a franchise, and the potential Lessor refuses to allow for such contingencies in the lease. The option gives the potential Tenant the time and opportunity to resolve the contingencies without being bound, while at the same time keeps the property on ice if he wants it. If a potential Tenant expresses a desire to immediately enter into a mutually binding, no-contingency lease, and the potential Lessor forces an unwanted option in order to get a front end payment that looks like a retainable option payment, the option format is a sham.

In addition to an option to get in, there can be an option to get out. A provision allowing a Lessor to terminate a lease upon payment of an agreed sum to the Tenant can be upheld as an option payment for the right to terminate, and not merely an attempt to liquidate damages.⁴³

Likewise, a payment for the Tenant's right to terminate can be structured as an option payment. In *Kuhlemeier v. Lack*⁴⁴ there was a provision that the \$25,000 deposit of the Tenant "is applied" upon the payment of rent pursuant to a schedule in the lease. There was a clause

42. *Welk v. Fainbarg*, 255 Cal. App. 2d 269, 63 Cal. Rptr. 127 (1967) (purchase option); *Sheveland v. Reed*, 159 Cal. App. 2d 820, 324 P.2d 633 (1958) (purchase option).

43. *Western Camps v. Riverway Ranch Enterprises*, 70 Cal. App. 3d 714, 138 Cal. Rptr. 918 (1977).

44. 50 Cal. App. 2d 802, 123 P.2d 918 (1942).

which provided that the Tenant could terminate the lease by a thirty-day notice at any time and be relieved of further duties. It further provided that upon such termination, Tenant would "forfeit" any interest he had in the \$25,000. The Tenant terminated in accordance with the clause. The Tenant also claimed termination on the basis of an asserted breach by the Lessor, but this issue was decided against the Tenant. The Tenant was unsuccessful in an attempt to recover the balance of the \$25,000, arguing that the retention was a void penalty or forfeiture. The court treated the payment as consideration for an option to terminate. It dealt with the language providing for forfeiture by pointing out that the clause, overall, was not an attempt to fix damages for breach, and it came into effect solely as a result of the Tenant's voluntary exercise of the option to terminate the lease. Since "forfeiture" implies a breach of duty on the part of the one losing his interest, the court concluded that the parties had misused the term. A forfeiture conditioned on breach would be void, but that was not the case here. In addition to the court's discussion of the payment as an option payment, the court points out that the lease provided the deposit "is" (not shall be) applied to the rent. This indicates application to rent at the time of payment, an advance payment of rent which is retainable by the Lessor, even absent a provision for retention. Preliminary recitals that the deposit was to guarantee the Tenant's faithful performance were not considered significant because there was no provision for forfeiture upon breach.⁴⁵

Some enterprising drafter will probably try to dress up a true penalty forfeiture as an option payment. For example, consider a clause that in effect provides that the Tenant's breach leading to termination shall be deemed an election by the Tenant to terminate, in which event the Lessor can keep the pot as consideration for exercise of the option to terminate. This pot will not hold water because the retention is, in substance, based on a breach. *Kuhlemeier* clearly distinguishes this provision from a true option.

On the other hand, some enterprising Tenant might try to maneuver a Lessor out of a true option payment after a termination based on Tenant's breach. The Tenant might argue that since the Tenant did not exercise his right to terminate the lease, retention of the payment after a breach termination would be a forfeiture. The success of this maneuver would seem to depend on the wording of the clause. If it provided that the Lessor could keep the payment only if the option to terminate

45. See also *Folden v. Lobrovich*, 171 Cal. App. 2d 627, 341 P.2d 368 (1959).

were exercised, the Tenant would be in good shape because the option would not have been exercised. This seems to be the way the clause in *Kuhlemeier* was worded. However, as noted above, that lease had a back-up argument for the Lessor, since there was also language of advance payment of rent. If the clause provided that the payment belonged to the Lessor as consideration for the option itself, rather than consideration for its exercise, the Tenant should not prevail. A payment for an option is not refundable just because the option has not been exercised. The optionee has received what he paid for, the option itself.

5. Summary and Comment

Les says, "I want some money up front." Tess says, "That's o.k. with me." Where do we go from there? Ideally, Les and Tess will decide what the money is for, and structure the front end payment accordingly. Practically, Les will probably try to structure the payment so that he can keep it, without offset, and Tess will probably try to structure it so that she gets it back to the extent that it exceeds actual damages and amounts due to Les. Thus, they will maneuver for a category label that will lead to retention for Les or refund for Tess, respectively.

The effect of the categories, based on the cases and absent application of statutory modification, can be summarized as follows:

1. *Security Deposit*—Refundable to Tenant in excess of damages and amounts due to Lessor.
2. *Liquidated Damages*—Likely to be treated as a void penalty or forfeiture, and thus refundable to Tenant in excess of damages and amounts due Lessor. But there is recent legislation, discussed below, that may give new life to certain liquidated damage provisions.
3. *Advance Payment of Rent, Bonus or Consideration for Execution*—Retainable by Lessor, without offset for damages due to Lessor. But there are construction and drafting factors that may lead to treatment as a security deposit. Also, there is recent legislation, discussed below, that may require a refund.
4. *Option Payment to Enter or Terminate Lease*— If a true option exists, retainable by Lessor without offset for damages or amounts due to Lessor.

The most fertile ground for disputes has been between the security deposit on the one side, and the advance payment of rent or bonus or consideration for execution on the other side. The security deposit is characterized by the Tenant's retention of a substantial interest in the

fund. The advance payment of rent, bonus or consideration for execution, on the other hand, is characterized by an absolute and unconditional payment to the Lessor, with title to the fund passing to the Lessor upon receipt. While this is simple in theory, in practice it is like stepping from tuft to tuft across a vast morass.

Is the distinction really one with only an illusory difference? In substance, a Lessor is selling, and a Tenant is buying, time segments of use of the premises. When the lease prematurely terminates: Tenant only receives part of the time segments; the Lessor gets paid for the time segments that were received, together with any damages if the Tenant breached; and the Lessor still has the remaining time segments to sell to others or use himself. If the advance payment of rent, bonus or consideration for execution rules are applied, the Tenant also pays, at least in part, for the time segments which he did not receive, and which were kept by the Lessor for resale or personal use. This is not like a sale of goods where part of the order is delivered and something happens to the rest before delivery, but after title has passed to the buyer. Here the remaining items, the time segments, are still in the Lessor's hands and available for his use or disposal. One might argue that in historical terms a lease is a present conveyance of title to the Tenant of the entire lease term, including all of its time segments. When the lease is prematurely terminated, however, the remaining time segments belong to the Lessor and he derives the benefit from them.

If a lease terminates, and the Tenant has paid for the time used, but he has not yet paid for the unused time, a collection by the Lessor, in excess of damages, would be treated as a penalty or forfeiture. This is because the Lessor would be extracting something for nothing. But if the Tenant has already made an advance payment of rent for the unused time, the Lessor can keep it. Even if we dress it up in the traditional explanation of an absolute payment to Lessor, with title passing upon receipt, is this any less something for nothing? The uneasy feeling that should arise while playing this shell game is expressed by Justice Moore's concurring opinion in *Kuhlemeier v. Lack*,⁴⁶ discussed above in connection with option payments. In that case, the payment was treated as an option payment, retainable by the Lessor. Justice Moore concurred, but he said:

I do so with deep anxiety in view of the precise allocation of the money to the payment of the rentals for specified months of the term of the lease. Since those months had not arrived, the moneys were never earned. My hesitancy arises from a deep-seated dislike for any scheme that transfers

46. 50 Cal. App. 2d 802, 123 P.2d 918 (1942).

to a person the property of his neighbor without adequate return.⁴⁷ In that case, the payment was consideration for Tenant's option to terminate and be discharged from further obligations, which the Tenant exercised, so he did receive something in return. What if there had been no option and it was just a straight advance payment of rent for the months following termination?

When the lease terminates through no fault of the Tenant, you cannot even say, "Tough luck, bad person, you brought it upon yourself." Even if the Tenant did bring about the termination through default, California has a strong policy against penalties and forfeitures. In *Freedman v. The Rector*,⁴⁸ a willfully defaulting buyer of real property was entitled to recover purchase price payments in excess of damages. Why not a defaulting Tenant, or even a non-defaulting Tenant, who has paid the purchase price for time segments not received? The court in *Freedman* points out that a penalty equal to net benefits conferred not only fails to take into consideration the degree of culpability, but its severity increases as the seriousness of the default decreases. This is just as true in a payment for time segments of a lease not received, as it is in a payment for a fee title not received.

The problem of something for nothing and the resulting effect of penalty or forfeiture is more apparent with an advance payment of rent than with a bonus or consideration for execution. The recipient of the bonus or consideration for execution can argue that the Tenant did in fact receive what was paid for, the execution of the lease. This seems to be based on the common law concept that a lease is a present conveyance of an estate to the Tenant. Arguably, the bonus or consideration is for this conveyance which has taken place upon execution. In most leases (absent a true option), execution as a separate consideration for the payment is an illusion worthy of a show at a magic castle.

The illusion of meaningful separate consideration has been rejected by California courts in a contract for sale of real property. It seems that in a lease, which California recognizes as a contractual relationship,⁴⁹ the illusion should not be given any greater substance. In *Rodriguez v. Barnett*,⁵⁰ a sale contract provided that a deposit made by the buyers could be retained by the seller as "consideration for the execution of this agreement." The court said that "[t]he mere recitation that the right of the seller to retain this deposit was in consideration for

47. *Id.* at 809, 123 P.2d at 922.

48. 37 Cal. 2d 16, 230 P.2d 629 (1951).

49. CAL. CIV. CODE § 1925 (West 1970).

50. 52 Cal. 2d 154, 338 P.2d 907 (1959).

executing this agreement, is insufficient to establish meaningful separate consideration."⁵¹

In *Caplan v. Schroeder*,⁵² the buyers gave the sellers a \$15,000 note outside escrow. The contract provided that the note was consideration for sellers entering into the agreement; if the sale were completed, the \$15,000 would be credited on the price; if the sellers defaulted, the note or money paid on it would be returned to the buyers; and if the buyers defaulted, the note and money paid on it would be retained by the sellers as consideration for entering into the agreement. The buyers willfully breached after paying the \$15,000, but were entitled to get the money back, less any damages suffered by the seller. The sellers argued that the note and its payment were consideration for entering the agreement and the buyers had received that for which they had bargained. The court, in rejecting this argument, made some important points which seem equally applicable to a lease bonus or consideration for execution.

1. Entering into an agreement is meaningless except as rights and obligations flow from the agreement. You must look to those rights and obligations to determine whether an initial payment is supported by separate consideration.

2. The payment cannot be treated like a true option payment because the buyers did not secure an option to purchase or not as they pleased, but rather entered into a mutually binding contract and made the payment in part performance of the contract.

3. The mere recitation that the payment was a consideration for executing the contract was insufficient to establish execution as meaningful separate consideration.

4. Even if the parties meant what they said in a recitation of consideration for execution, meaningful separate consideration is not established. The sellers executed the agreement in consideration of the buyers' agreement to purchase on all of the terms stated, not in exchange for the payment alone.

The court in *Caplan* said that since it was only because of the buyers' default that the sellers were given the right to keep the payment, the provision was void under Civil Code section 1670 as an attempt to fix the amount of damage or compensation for breach in anticipation thereof. This indicates that perhaps the sellers' only mistake was in tying the retention to the buyers' breach, rather than using absolute and

51. *Id.* at 160, 338 P.2d at 910-11.

52. 56 Cal. 2d 515, 364 P.2d 321, 15 Cal. Rptr. 145 (1961).

unconditional language of retention unrelated to breach. However, the court's reasoning mentioned above demonstrates a broader basis for the decision—execution of the agreement, absent a true option, is not separate meaningful consideration for the payment.

Suppose the owner of property is considering renting it for twelve months and he and the prospective Tenant consider the aggregate rental value for the twelve months to be \$12,000. They can set it up in a number of ways, for example: (1) \$1,000 per month rent; (2) a bonus or consideration for execution of \$11,988, and rent of \$1 per month; or (3) a bonus or consideration for execution of \$2,000, rent of \$1,000 per month for the first eight months and \$500 per month rent for the last four months. While there can be numerous variations, the economic substance of the transactions is the same, except for the value to the Lessor of the use of the Tenant's money in the case of advance payments. However, calling the payment a bonus or consideration for execution does not make it any less in substance a payment for future time segments of use. This is not to imply that each month must be given the same value or that only the later months should be higher to reflect inflation or increased market value. The rent for some months during the term might be higher or lower to reflect legitimate differences in values of the months, for example in a seasonal recreation location or in a seasonal business such as a greeting card store.

The recurring talk (and some recent action) of rent control, either as a Tenant relief device or as part of overall price-wage stabilization, puts an interesting focus on the bonus or consideration for execution. If it is truly "rent" that is controlled and the fixed rate for a certain unit is \$100 per month, but the owner thinks it is worth \$150 per month, he could give a one-year lease at \$100 per month rent with a bonus or consideration for execution of \$600. However, it is not likely that this would slip through the fence of rent constraints because in substance they seek to control the consideration received for time segments of use. In substance, the \$600 as well as the \$100 per month, regardless of their labels, are consideration for these time segments.

The maxim of jurisprudence, that the law respects form less than substance, recognized in Civil Code section 3528,⁵³ should be given effect. Unless the California policy against penalties and forfeitures is changed, an advance payment of rent, bonus and consideration for execution should be removed from their protected status. If they represent payment for something not received, they should be subject to refund

53. CAL. CIV. CODE § 3528 (West 1970).

in excess of damages and amounts due to the Lessor. An advance payment of rent for time segments following termination and vacation by a Tenant is unearned and should be refunded. A bonus or consideration which is labeled "for execution of the lease," but which is in substance additional consideration for the time segments of the lease term, should be prorated over the initial term of the lease. When the lease is prematurely terminated, the portion attributable to the time segments following termination and vacation by the Tenant should be refunded.

B. Statutory Provisions

The legislature has enacted three statutes dealing with the refund of front end payments: the original Civil Code section 1950.5,⁵⁴ operative January 1, 1971; the revised Civil Code section 1950.5, applicable to residential tenancies, operative January 1, 1978; and the new Civil Code section 1950.7, applicable to non-residential tenancies, operative January 1, 1978. Basically, these statutes require the return of certain types of front end payments, less certain offsets. The following is an analysis of revised section 1950.5 and new section 1950.7, and the ways in which they have altered the prior treatment of front end payments.

1. Type of Tenancy

a. Residential

Revised Civil Code section 1950.5 applies to rental agreements for residential property used as the dwelling of the Tenant. Note that this coverage is in terms of the type of tenancy use, not just the type of property. For example, suppose the owner of an apartment building master leased the entire building to an operator/master Tenant and the operator/master Tenant then rented the individual apartments to Tenants for occupancy. The master lease would not be subject to this statute even though the property itself is residential. However, the rental agreements between the master Tenant and the occupant Tenants would be subject to it.

The word "dwelling" contained in this statute is given further definition in Civil Code section 1940,⁵⁵ operative January 1, 1977. A dwelling unit means "a structure or the part of a structure that is used as a

54. Note that this statute was originally misnumbered "1951," so some of the early commentaries and cases concerning it refer to the wrong number. The real "1951" is the introductory section to the Lessor remedies legislation operative July 1, 1971.

55. CAL. CIV. CODE § 1940 (West Supp. 1978).

home, residence, or sleeping place by one person who maintains a household or by two or more persons who maintain a common household." Persons who hire dwelling units include "tenants, lessees, boarders, lodgers, and others, however denominated." However, persons occupying hotels, motels, and certain similar facilities, with characteristics mentioned in section 1940(b) are not included.

b. Non-residential

New section 1950.7 applies to a rental agreement for other than residential property. The language of this statute standing alone might be misinterpreted because it seems to refer just to the type of property. However, since this statute was part of the same legislation that revised section 1950.5, it appears that the definition of "other than residential property" should be construed in concert with the definition of "residential property" in section 1950.5, *i.e.*, used as the dwelling of the Tenant. Thus, in the example above where an owner/master Lessor leased an apartment building to an operator/master Tenant, who then rented individual units to Tenants for occupancy, although the property itself was residential, the master lease would be covered by section 1950.7.

2. Applicability Date

a. Residential

The key dates for application of the statute vary depending upon the portion of the statute involved.⁵⁶ The provisions of the revised statute which are the same as the original Civil Code section 1950.5 apply to payments of deposits *made* on or after January 1, 1971. The new provisions requiring an accounting by the Lessor within two weeks after the Tenant vacates apply where the *termination* occurs on or after January 1, 1978. The other new provisions apply to tenancies, leases, or rental agreements *created or renewed* on or after January 1, 1978. The discussion of the residential provisions below will indicate the particular controlling date.

b. Non-residential

The new statute, which states that it declares existing law, applies to tenancies, leases, or rental agreements *created or renewed* on or after January 1, 1971.⁵⁷ Since 1971, there has been some confusion in prac-

56. *Id.* § 1950.5(k).

57. *Id.* § 1950.7(g).

tice over whether the original section 1950.5 applied to non-residential as well as residential tenancies. The new statute, in effect, says that the original section 1950.5 applied to both non-residential and residential tenancies.

3. Types of Front End Payments Covered

a. Residential

The statute applies to "security for a rental agreement" which is defined as "*any* payment, fee, deposit or charge, including, but not limited to, an *advance payment of rent*, used or to be used, for *any* purpose, including, but *not limited* to, any of the following:" (1) rent default; (2) repair of Tenant caused damage; and (3) clean-up upon termination.⁵⁸

The original section 1950.5 included a payment or deposit "the primary function of which is to secure the performance of a rental agreement." It excluded a "payment or deposit, including an advance payment of rent, made to secure the execution of a rental agreement." Although a security deposit was clearly covered, this rather slippery language left the Lessor room to argue that an advance payment of rent, bonus or consideration for execution was not covered.

The revised statute eliminates the distinction between a payment to secure performance and one to secure execution. It covers *any* payment, fee, deposit, or charge. It expressly includes an advance payment of rent. It covers a payment for *any* purpose, although the non-exclusive examples in the section seem typical of a security deposit. It seems to get rid of the distinctions based on labels such as advance payment of rent, bonus or consideration for execution which have allowed Lessors to retain payments without regard to whether Tenants have in fact received something in return. In effect, the statute is saying that regardless of what you call it, the payment is to be refunded to the extent it exceeds certain amounts due and certain damages. Thus, the statute should be considered to cover a security deposit, an advance payment of rent, and a bonus or consideration for execution of the lease.

Despite the broad language of coverage in the statute, there are some payments, fees, or charges which should not be subject to the refund provisions. Although the statute mentions a payment for "*any* purpose," the non-exclusive examples (rent default, repair of tenant caused damages, and clean-up upon termination) have a common characteristic—the payment is for something in the future not yet earned by the

58. *Id.* § 1950.5(a), (b) (emphasis added).

Lessor, or a damage not yet sustained by him. Even though these examples are not exclusive, they should be used for guidance in determining the basic characteristics of the purpose of payments covered by the statute. The broad language in the statute is like a "one size fits all garment"—a good idea in theory, but not that flexible in practice. If there is a payment, fee, or charge that is for something actually provided by the Lessor, or for a cost actually incurred by him, at the beginning of the term, the refund concept of the statute should not apply. For example, at the request of the Tenant, the Lessor redecorates in special colors, cuts a doggie door in the wall, and removes and replaces doors and windows to accommodate a move-in of special furniture of the Tenant. Another example is a charge to pay for a credit check. A more difficult example is a preparation charge. After one Tenant moves out and before another moves in, there are generally two categories of work involved on the premises. The first covers damages and lack of cleaning beyond ordinary wear and tear. These are items for which the vacating Tenant can be held responsible. The second category covers work which, although not necessary to make the unit habitable, spruces the place up and makes it a more pleasant place for the new occupant. Examples are having the walls touched-up or repainted, or having the carpets shampooed and drapes cleaned to enhance their appearance. A separate charge for the cost of this work, done to make the dwelling look more pleasant in appearance for the new Tenant, should not be covered by the refund provisions of section 1950.5, particularly if the new Tenant has been given the choice of having the work done or not.

A true option payment, discussed above in section III. *A.4.*, should not be considered as included in the statute. The option is really independent of the bilateral relations of the tenancy itself and the Tenant has received what he paid for. It is not in any sense security for a rental agreement, even under the broad definition of the statute.

A front end payment for "liquidated damages" involves special statutory and judicial requirements discussed below. If the agreement for liquidating damages does not meet the requirements, the payment is in essence a security deposit and should be covered by section 1950.5. If the agreement does meet the requirements for liquidating damages, but the breach for which the damages are liquidated does not occur, the payment is a security deposit for damages not sustained and it should also be covered by section 1950.5. However, if the agreement meets the liquidated damage requirements and the breach that is liquidated occurs, the payment should be governed by the specific law applicable to

liquidated damages and should not be deemed covered by section 1950.5. As will be seen in the later discussion on liquidated damages, the latter situation is not likely to occur in practice with residential tenancies. One who bets on the enforceability of liquidated damages in a residential tenancy is fond of longshots.

The effective date for subjecting a front end payment to section 1950.5 is a bit of a problem. To the extent that a payment was covered by the original section, the revised statute applies to a payment made on or after January 1, 1971. To the extent the payment was not covered by the original statute, but is covered by the revised one, the statute applies to tenancies, leases, or rental agreements created or renewed on or after January 1, 1978.⁵⁹ A security deposit was covered by the original statute, so the January 1, 1971 date applies. But, although the revised statute clearly covers an advance payment of rent and appears to cover a bonus or consideration for execution, there is some confusion over whether they were covered by the original statute. Thus, it is unclear whether the 1971 or 1978 date applies. The original statute included payments to secure performance and excluded payments to secure execution. Since this distinction is carried forward in the statute on non-residential tenancies, and discussed immediately below, it will not be repeated here.

b. Non-residential

Section 1950.7 and its mandatory refund requirement apply to any payment or deposit "the primary function of which is to secure the performance of a rental agreement . . . or any part of such an agreement, other than a payment or deposit, including an advance payment of rent, made to secure the execution of a rental agreement" ⁶⁰ If the payment or deposit is made to secure *performance*, it is covered by the statute. If the payment or deposit, including an advance payment of rent, is made to secure *execution*, it is excluded from coverage.

Clearly, a security deposit type front end payment is covered by the statute. But what about an advance payment of rent, or bonus or consideration for "execution"? The language in the statute is the same as the original section 1950.5. A study concerning liquidated damages prepared for the California Law Revision Commission commented on the coverage of the original section 1950.5. The article states, "The legislature attempted to reverse cases that permitted the landlord to retain

59. *Id.* § 1950.5(k).

60. *Id.* § 1950.7(a).

advance payments under the labels of prepaid rent or bonus for entering into the lease”⁶¹ Hopefully, this is what the legislature did. Unfortunately, however, the language used in the original section 1950.5 and repeated seven years later in the new legislation, is confusing. Unlike scotch, it did not improve with age. In addition to the problem of the confusing language, it is unclear why the legislature used broader language when it revised section 1950.5 with respect to residential tenancies, but retained the original language when it adopted section 1950.7 with respect to non-residential tenancies. If the original language had already eliminated the distinctions between a security deposit, an advance payment of rent, and a bonus or consideration for “execution,” it seems the language in the residential and non-residential statutes could have remained the same.

The payments or deposits excluded from coverage are those made to *secure the execution* of a rental agreement. It seems that the only front end payment which clearly fits within that phrase is an option payment given to the Lessor in exchange for an option that binds the Lessor to execute a rental agreement. This payment secures the execution of a rental agreement. On the other hand, a bonus or consideration for “execution” given at the time of entering a rental agreement, with its bilateral relationships, does not in substance “secure the execution” of the rental agreement. As discussed above in section III. A.5., the execution itself is not meaningful separate consideration in this situation.

The incorporation of the language “an advance payment of rent” in the statutory language which excludes a payment or deposit to secure execution from the scope of the statute is troublesome. It seems to say that an advance payment of rent is not covered by the statute, but is so excluded only if it is paid to secure the execution of the rental agreement. In substance, an advance payment of rent is a payment for a future time segment of use, not a payment to secure execution. Perhaps the language refers to a situation where an option payment is made to secure the execution of a rental agreement and a portion of that payment is to be applied to rent upon exercise of the option.

The advance payment of rent, bonus and consideration for “execution,” to the extent that they represent payment for something not yet received, should be subject to refund in excess of damages and amounts due to the Lessor. This was discussed above in section III.A.5.

Regarding the difference in language in the residential statute, even though there are many situations where there is a viable argument that

61. Sweet, *Liquidated Damages in California*, 60 CALIF. L. REV. 84, 104 (1972).

a residential Tenant should receive greater protection than a non-residential Tenant, this is not such a situation. The retention of a front end payment in excess of the amount of compensation to which a Lessor is entitled is a penalty or forfeiture, regardless of the residential or non-residential character of the tenancy. Although it can be argued that the non-residential statute already covers the typical advance payment of rent, bonus or consideration, it should be clarified to avoid unnecessary litigation. The non-residential tenancy has already been the source of the vast majority of appellate litigation over the labeling of front end payments, and the statute should put an end to the matter instead of perpetuating it.

The last type of front end payment, one for liquidated damages, is in essence a security deposit held to secure the Tenant's performance. If the agreement for liquidated damages does not meet the special statutory and judicial requirements for validity, the payment should be treated as any other security deposit covered by section 1950.7. If the agreement does meet the liquidation requirements, but the breach for which the damages are liquidated does not occur, the payment should be treated as a security deposit for damages not sustained and should be subject to the refund provisions of the statute. If the agreement meets the liquidation requirements and the liquidated breach does occur, the payment should be governed by the specific law applicable to liquidated damages, rather than section 1950.7.

4. Maximum Amount

a. Residential

There is a ceiling on the amount which the Lessor can demand or receive as a front end payment over and above the first month's rent.⁶² The limits are: an amount equal to two months' rent for unfurnished premises; and an amount equal to three months' rent for furnished premises. The rent for the first month can be collected in addition to these amounts.

There is a peculiar exception. It states that the ceiling provision "shall not be construed to prohibit an advance payment of *not less than* six months' rent where the term of the lease is six months or longer."⁶³ If you think this is a misprint, you are wrong. The exception seems to say that in a lease of six months or longer, the Lessor can get an amount equal to six months' rent or more, but he is in trouble if he

62. CAL. CIV. CODE § 1950.5(c) (West Supp. 1978).

63. *Id.* (emphasis added).

collects less, for example, only five months' rent. This interpretation of a minimum payment would be inconsistent with the payment limiting function of the statute. The exception would have made more sense if it had said "not *more* than" six months' rent. Perhaps it means that if the lease is six months or longer, the Lessor can collect advance rent for the seventh month and beyond without restriction, but the first six months are subject to the statutory limits. This exception should be clarified.

The statute contains another exception for fees or charges for certain alterations made at the request of the Tenant. This exception makes sense.

The amount limitations are new, so the applicable date is January 1, 1978.

b. Non-residential

There is no statutory limit on the amount of front end payments which can be collected by a Lessor of non-residential property.

5. Amounts Lessor Can Claim from Deposit

The provisions for Lessor claims against the amount covered by the statutes for residential and non-residential tenancies are substantially the same,⁶⁴ so they will be dealt with together with any distinctions noted.

The Lessor can claim *only* amounts reasonably necessary to remedy rent defaults, to repair damages caused by the Tenant, and to clean the premises upon termination.

The use of the word "only" in limiting the claim to the three categories mentioned is unfortunate. There can be legitimate claims of a Lessor against a Tenant for items which do not fit neatly into those three categories. Giving a broad construction to the word "rent" and including delinquent charges equivalent to rent will help.⁶⁵ For example, in a lease which requires the Tenant to pay real property taxes and to provide insurance coverage, the payment of taxes and premiums should be considered rent in the broad sense. Even though the payment is not made directly to the Lessor, it is a payment on his behalf in lieu of the Lessor's collecting more money directly from the Tenant and then paying the tax collector and insurance company. However, an expansive construction of the word "rent" cannot conveniently be applied in all

64. *Id.* §§ 1950.5(e), 1950.7(c).

65. *See, e.g., id.* § 1951(a).

situations in which the Lessor has a legitimate claim. Suppose, for example, that the Tenant breaches an express clause requiring him to make repairs of damage to the premises even if he did not cause the damage, or suppose that the Tenant of a commercial lease breaches a non-competition clause. Unless the word "rent" is stretched to cover any duty the Tenant owes to the Lessor, the Lessor cannot use the amount on hand for damages suffered by reason of such breaches. This will particularly cause problems with non-residential leases which typically have broad Tenant obligations. At least the statute covering non-residential leases should be clarified to include claims for damages sustained by reason of a breach of any of the Tenant's obligations.

Regarding a claim for damages to the premises caused by the Tenant, the residential section excludes "ordinary wear and tear," but the non-residential section does not mention this exclusion. This is not a significant difference since the Tenant would generally not be responsible for ordinary wear and tear anyway. Regarding a claim for cleaning upon termination, the residential section covers cleaning "if necessary" but the non-residential section does not say "if necessary." It seems we can assume that if the cleaning were not necessary, the Lessor could not collect for it even without those magic words in the statute.

There is a troublesome phrase in the non-residential section which was not included in the residential section. After saying that the Lessor can claim only amounts reasonably necessary for the three categories discussed above, it goes on to say "if the payment or deposit is made for any or all of those specific purposes." Hopefully, this will not be construed to mean that the lease itself has to specifically mention the three categories in order for the Lessor to assert a claim against the fund. Such a construction would lead to the silly result that a general recital such as "the payment is to secure performance of the Tenant's obligations" would be insufficient to allow the Lessor to claim delinquent rent from the fund. The word "specific" should mean the specific categories set forth in the statute, not that those categories must be specifically set forth in the lease. General language in the lease which by its nature includes the three categories should be sufficient. This phrase in the statute is a needless source of petty dispute and should be eliminated.

Since the language of these provisions is substantially similar to the original section 1950.5, the effective date of January 1, 1971 should be applicable.

6. Refund Time Limit and Penalty

Both the residential and non-residential sections require a refund of the remaining balance within two weeks.⁶⁶ In a residential tenancy, the two-week period is measured from when the Tenant *vacated* the premises. In a non-residential tenancy, it is measured from when the tenancy is *terminated*. Using termination to start the time running was a poor choice. The tenancy might be terminated, but the Tenant could withhold possession for more than two weeks, and the Lessor would have to refund the money before he could determine the extent of his damages. The two weeks should start only when the Tenant vacates.

Both the residential and non-residential sections provide that a "bad faith" retention of the money, or any portion of it, in violation of the section may subject the landlord or his transferee to damages not to exceed \$200, in addition to actual damages.⁶⁷ The residential section expressly places the "burden of proof as to reasonableness of the amounts claimed" on the Lessor. The non-residential section is silent as to this burden.

Since the language of these provisions is substantially similar to the original section 1950.5, the January 1, 1971 effective date should be applicable.

There had been some question as to whether the punitive damages of \$200 could be recovered in small claims court. When relatively small amounts are involved, most Tenants will not go to the trouble and expense of getting a lawyer for a municipal court action. The residential section now provides that actual and punitive damages can be recovered in small claims court if they are within the jurisdictional amount.⁶⁸ The same is probably true in a non-residential situation, although the non-residential section does not mention small claims court recovery.⁶⁹

7. Priority of Tenant's Claim

Both the residential and non-residential statutes provide that the Lessor shall hold the money for the Tenant and that the Tenant's claim is to be prior to the claim of any creditor of the Lessor.⁷⁰ This seems to be a recognition that the Tenant has a continuing substantial interest in the payment or deposit. The non-residential section excepts a trustee in bankruptcy from the Tenant's priority.

66. *Id.* §§ 1950.5(e), 1950.7(c).

67. *Id.* §§ 1950.5(h), 1950.7(f).

68. *Id.* § 1950.5(j). CAL. CIV. PROC. CODE § 116.2 (West Supp. 1978).

69. 59 OP. ATT'Y GEN. 321 (1976).

70. CAL. CIV. CODE §§ 1950.5(d), 1950.7(b) (West Supp. 1978).

These provisions are the same as the original Civil Code section 1950.5, except that the original statute applied the exception of a trustee in bankruptcy also to a residential lease. Thus, for most purposes, the January 1, 1971 effective date will be applicable.

8. Accounting

a. Residential

A form of accounting by the Lessor is required in three different situations:

1. An "itemized written statement of the basis for, and the amount of, any security received and the disposition of such security" must be given within two weeks after the Tenant vacates.⁷¹

2. The same type of a statement is required within a reasonable time if the Lessor returns the unused balance of the money upon a termination of the Lessor's interest in the property.⁷²

3. A notice of "claims made against the security" is required, within a reasonable time, if the Lessor transfers the unused balance of the security to his successor upon termination of the Lessor's interest in the property.⁷³

The applicable effective date in the first situation is a termination on or after January 1, 1978. The applicable date in the second and third situations is a creation or renewal on or after January 1, 1978. If a Lessor's interest in a pre-1978 lease is terminated, even though the statute technically does not require an accounting, it would seem to be fair and good practice to give one anyway.

b. Non-residential

The only situation in which any type of an accounting is required in a non-residential tenancy is where a Lessor transfers the unused balance of a front end payment to his successor upon termination of the Lessor's interest in the property.⁷⁴ A notice of "claims made against the payment or deposit" must be given to the Tenant.

When the lease terminates or when the Lessor returns the unused balance upon termination of the Lessor's interest in the property, even though the statute does not require an accounting, it would seem to be fair and good practice to give one anyway.

71. *Id.* § 1950.5(e).

72. *Id.* § 1950.5(f)(2).

73. *Id.* § 1950.5(f)(1).

74. *Id.* § 1950.7(d)(1).

9. Relief from Liability when Lessor Transfers

The provisions applicable to residential and non-residential tenancies are substantially similar. When a Lessor's interest is terminated by sale, assignment, death, appointment of a receiver, or otherwise, the Lessor (or his estate) can be relieved of further liability for front end payments by following one of two simple alternatives, within a reasonable time.⁷⁵

First, the Lessor or his agent can transfer the unused balance to the successor and notify the Tenant. The transferee takes on all of the rights and obligations of a landlord with respect to the security, payment, or deposit.⁷⁶ The statute should be construed in a manner that limits the transferee's obligation to the amount received from the Lessor, since the transferee is in a poor position to evaluate the legitimacy of deductions by the transferor. In the case of a sale, it should not make any difference whether the transfer is made by an actual transfer of funds or a credit against the sale price. The economic effect is the same.

The notice to the Tenant of such a transfer must be given by personal delivery or certified mail and must specify claims made against the fund and give the transferee's name and address. In the case of a residential tenancy, it must also give the transferee's telephone number. If the notice is given by personal delivery, the statute says the Tenant "shall" acknowledge receipt and sign the Lessor's copy. Although it is certainly good practice to obtain this type of proof of service, some Tenants will refuse to sign for various reasons. One reason might be a mistaken belief that signing the receipt would be an admission of the correctness of the Lessor's figure for the balance remaining. Although most Tenants know that signing a traffic ticket does not admit guilt, many will be leery of signing a Lessor's form. If the Tenant does refuse to sign, it would be a good idea to have the server sign a declaration to that effect on the Lessor's copy.

Under the second alternative, the Lessor can return the unused balance to the Tenant to be relieved of further liability, but it is unlikely that the bird in hand will be given up in many cases. In the case of a residential tenancy, the Lessor must also give the Tenant an accounting with the refund. Even though the statute does not require an accounting for a non-residential tenancy, it would seem to be fair and good practice for the Lessor to give one anyway.

75. *Id.* §§ 1950.5(f), 1950.7(d).

76. *Id.* §§ 1950.5(g), 1950.7(e).

Since these provisions are substantially similar to the original Civil Code section 1950.5, January 1, 1971 is the applicable effective date.

Compliance with the requirements of the statute gives the Lessor a very important benefit not otherwise available. The obligation of a Lessor with respect to a deposit has been considered a personal one, putting the Lessor in a position of a debtor to the Tenant. The obligation of the Lessor continues despite a transfer of his interest to a successor.⁷⁷ Even though the transferring Lessor might get reimbursement from the transferee,⁷⁸ and even though the Tenant might choose to go after the transferee,⁷⁹ it is much better for the Lessor to get off the hook completely and to avoid future surprises. Also, it makes more practical sense to have the successor, the new Lessor, with the control over and responsibility for the money because he will have the continuing relationship with the Tenant.

10. Waiver by Tenant

a. Residential

There are two statutes that expressly prohibit a waiver of the Tenant's entitlement to a refund when the tenancy is residential. Revised section 1950.5 applies to a tenancy, lease, or rental agreement created or renewed on or after January 1, 1978.⁸⁰ Civil Code section 1953 applies to leases and rental agreements executed on or after January 1, 1976.⁸¹

If the tenancy relationship was created prior to January, 1976, the validity of a waiver agreement is still in question. However, it seems that a valid waiver is unlikely. The original section 1950.5 did not expressly cover the question of waiver. In *Bauman v. Islay Investments*,⁸² the court was not very impressed with arguments that the statute's failure to expressly say "non-waivable" indicated permission to waive. However, the court did not find it necessary to determine whether a Tenant's entitlement to a refund under the statute was waivable. The court concluded that even if waivable, there was not a sufficient waiver present in the facts.

77. *Federated Mortgage Inv. v. American Sav. & Loan Ass'n*, 47 Cal. App. 3d 917, 121 Cal. Rptr. 137 (1975); *Gallagher v. McMann*, 119 Cal. App. 688, 7 P.2d 204 (1932); *Walter H. Sullivan, Inc. v. Johnson*, 116 Cal. App. 591, 3 P.2d 72 (1931).

78. *Walter H. Sullivan, Inc. v. Johnson*, 116 Cal. App. 591, 3 P.2d 72 (1931).

79. *Thompson v. Swiryn*, 95 Cal. App. 2d 619, 213 P.2d 740 (1950).

80. CAL. CIV. CODE § 1950.5(i), (k) (West Supp. 1978).

81. *Id.* § 1953(a)(1), (c).

82. 30 Cal. App. 3d 752, 106 Cal. Rptr. 889 (1973).

The rental agreement in *Bauman* stated in capital letters: "THIS IS YOUR NON-REFUNDABLE CLEANING FEE RECEIPT." It also stated, "The cleaning fee is payable in full, in advance, prior to occupancy and is NON-REFUNDABLE." Do you get the feeling from this language that the Tenant should not expect to get the money back? Not so. Regarding whether the payment by the Tenant was made to "secure performance," the court pointed out that the "house rules" included in the agreement provided that the Tenant was taking possession of the unit in good condition and would diligently maintain it. The court concluded that the cleaning fee had no possible purpose other than protection of the Lessor against costs of restoring a unit not maintained. Regarding the requirements for a valid waiver, the court said the language in the rental agreement was clear and prominently printed, so the Tenant could not honestly claim ignorance of its presence. However, the court said that a waiver of a statutory right could not be effective unless it appeared that the waiving party had been fully informed of the existence of that right, its meaning, and the effect of the waiver, and that he fully understood the explanation.

Even if the Tenant's rights under the original section 1950.5 were waivable in a pre-1976 agreement, looking for a waiver that meets the *Bauman* requirements in a pre-1976 residential agreement is like riding an escalator backwards—not a very moving experience.

If one believes that people occasionally submit to temptation, there is another problem to consider. Some Lessors feel that even though a waiver is void, on the average only a few Tenants will bother fighting for a refund. Some Lessors will succumb to the temptation to play the percentages and include a waiver in the lease and then just refund when pressed. Even the prospect of an occasional \$200 penalty for bad faith might not be a sufficient deterrent to such a practice. Where the Lessor has followed this practice, a class action might be an appropriate means of reinforcing rectitude. In a second *Bauman* case,⁸³ although the plaintiff had failed to adequately establish the requirements for a class action, the court expressed optimism about qualifying this type of a situation for a class action, and pointed out that a primary and salutary purpose of a class action is to redress small wrongs that might otherwise go unredressed.

b. Non-residential

There is no express provision prohibiting a waiver in a non-residen-

83. *Bauman v. Islay Invs.*, 45 Cal. App. 3d 797, 119 Cal. Rptr. 681 (1975).

tial tenancy. The language in Civil Code section 1950.7 is substantially the same as the original section 1950.5. Thus, the issue raised, but not resolved in the first *Bauman* case, discussed above, is still present. Does the absence of a prohibition indicate that a waiver is permitted? It might be argued that since revised section 1950.5 (residential) contains an express prohibition and section 1950.7 (non-residential) does not, the omission is an expression of waivability. In the first *Bauman* case, a similar argument was made that Civil Code section 1942.1, enacted in the same legislative session as the original section 1950.5, expressly prohibited waiver of a Tenant's habitability protections, thus if the legislature intended refund protections to be non-waivable, similar language would have been included in section 1950.5. The court was not persuaded. However, the argument may be more persuasive in comparing the revised section 1950.5 and section 1950.7. These two sections were not only enacted in the same session, they were part of the same piece of legislation, dealing with the same topic of front end payments, and there is an intentional pattern of broader protection for a residential Tenant.

However, though it might be effectively argued that the omission from the non-residential statute was intentional and that the statute itself was not designed to prevent a waiver of a refund, it seems that a waiver should still be void. The statute covers a payment or deposit to secure the Tenant's performance. A refund is at issue only when the payment or deposit exceeds the amount reasonably necessary to compensate the Lessor for failure of performance. To the extent that the payment or deposit exceeds compensation to the Lessor, its retention, by way of waiver or otherwise, is a forfeiture or penalty. A forfeiture or penalty is prohibited independently of section 1950.7.

C. Transfer of Lessor's or Tenant's Interest in the Property

The receipt of a refundable payment or deposit creates a personal obligation of the Lessor recipient to the Tenant that is not automatically extinguished when the Lessor transfers his interest in the property to a successor. However, there is a statutory procedure, discussed in section III.B.9. above, which allows the Lessor to relieve himself from future liability by transferring the fund to the successor or returning it to the Tenant. If the statutory procedure is not complied with or the front end payment is not covered by the statute, the transferring Lessor seeking protection will have to try to get a release from the Tenant, or an indemnity from the transferee.

The original Tenant who enters into the lease or rental agreement

and pays the refundable payment or deposit is entitled to recover it. This is recognized by language in both the residential and non-residential tenancy statutes which states that the Lessor shall hold the money "for the tenant who is party" to the lease or rental agreement.⁸⁴ Although a Tenant can assign his rights to a successor, a mere assignment of the leasehold estate, without an assignment of rights to the payment or deposit, will not shift the right to recover.⁸⁵ This is a matter which should be given express attention in drafting lease assignments in order to avoid later disputes between assignor and assignee.⁸⁶ Not only should the assignment price and prorations (*e.g.*, taxes, insurance, rents, utilities) be clear, but also the handling of the front end payment should be spelled out. In addition, the Lessor should determine whether or not the entitlement to refund has been assigned or retained so that the proper party can be paid if and when a refund comes due.

IV. LIQUIDATED DAMAGES

A. Nature

The parties to a lease or rental agreement sometimes agree that in the event a particular breach occurs, a certain amount will be the agreed damages or compensation to the Lessor for such breach. Alternatively, the parties might provide for a formula to calculate the amount of damages or compensation. In effect, the provision says that even though there has been no breach yet and the parties do not know what the exact actual damages will be when it occurs, if the breach does occur, the Lessor will be entitled to a specific amount or specifically determinable amount, no more and no less.

Usually the liquidated damage provision is tied in with a front end payment, which in substance is a security deposit for the liquidated damages if the breach occurs.

There are both advantages and dangers of liquidated damages to keep in mind while evaluating liquidation requirements.⁸⁷ A provision for liquidated damages may avoid the cost, difficulty, and delay of proving damages, and, in certain cases, may avoid problems in proving

84. CAL. CIV. CODE §§ 1950.5(d), 1950.7(b) (West Supp. 1978).

85. *Reidy v. Miller*, 85 Cal. App. 764, 767, 260 P. 361, 362 (1927).

86. *See, e.g., Monogram Indus., Inc. v. Statewide Theatre Circuit, Inc.*, 231 Cal. App. 2d 868, 42 Cal. Rptr. 413 (1965) (under an agreement to assign remainder of leasehold, seller not entitled to credit from buyer for \$10,000 paid to Lessor earlier under lease reducing final year's rent by \$10,000).

87. CALIFORNIA LAW REVISION COMMISSION, ANNUAL REPORT, 13 CALIFORNIA LAW REVISION COMMISSION REPORTS, RECOMMENDATIONS, AND STUDIES 1601, 1740-41 (1976) [hereinafter cited as 1976 ANNUAL REPORT].

causation and foreseeability, or problems with proving certain types of damages. It allows a party to put a known ceiling on his potential liability for his breach. Also, it may aid judicial administration by eliminating or shortening some litigation. On the other hand, there is a danger that liquidation may be used oppressively and unfairly when one party has the power to dictate the terms of the agreement, or when one party does not understand the effect of the provision.

B. Pre-July 1, 1978 Clauses

The development of liquidated damage requirements, prior to the recent legislation covered below, is mentioned briefly in section III.A.2. above, and is given thorough treatment in an excellent study prepared by Justin Sweet for the California Law Revision Commission.⁸⁸ Thus, the requirements for pre-July 1, 1978 clauses will just be briefly summarized here as a background to the recent legislation. The most practical way of looking at the requirements is in terms of what must be done in litigation concerning a liquidated damage clause, as was discussed in the *United Savings & Loan Association v. Reeder*.⁸⁹

The proponent of the liquidated damage clause has the burden of proving, by a preponderance of the evidence, the following foundational facts:

1. *There must be an agreement fixing an amount to be considered as liquidated damages for breach.* It seems apparent from the nature and function of liquidated damages that the purpose of the requirement of fixing damages is to prevent a clause that gives the damaged party a choice between the liquidated damages and actual damages. Such a choice would be contrary to the settlement nature and function of liquidating damages. The clause should provide for the sole money remedy for a particular breach. However, just because you cannot have your cake and eat it too, does not mean that you cannot use a cupcake approach and liquidate just certain kinds of breaches and damages, while leaving different kinds of breaches and damages subject to proof of actual damages. In fact, when you consider the second foundational fact, this cupcake approach seems advisable.

2. *It would be impracticable or extremely difficult to fix the amount of actual damages.* It is the time when the contract is entered, rather than the time of breach, that impracticability or extreme difficulty must exist. It is possible to have a situation where it is impracticable, but not

88. Sweet, *Liquidated Damages in California*, 60 CALIF. L. REV. 84 (1972). See also 1976 ANNUAL REPORT, *supra* note 87, at 1739-64.

89. 57 Cal. App. 3d 282, 129 Cal. Rptr. 113 (1976).

extremely difficult, to fix actual damages. For example, such a situation exists when the amount of actual damages is small, but the cost of ascertaining the damages would exceed the damages.⁹⁰

3. *The agreed amount must be the result of a reasonable endeavor by both parties to determine an amount that bears a reasonable relationship to actual damages.* Combining the second and third requirements seems like saying it has to be tough to determine actual damages, but you have to come close.

If the proponent establishes the three foundational facts, there is a presumed fact that the liquidated damage amount represents the actual damages suffered by reason of the breach.

The opponent of the clause may introduce evidence to negate the foundational facts, or the presumed fact, or both. Thus, even if the proponent establishes all of the foundational facts, the opponent can still attack the amount of liquidated damages as unreasonably in excess of actual damages.

The drafter and proponent of a liquidated damage clause in California has been like a salmon swimming upstream to mate—very few make it, and it might not be worth the trip when you get there. As pointed out in section III.A.2. above, most of the cases dealing with liquidated damages clauses in leases have knocked them out, usually on the basis that the actual damages were not impracticable or extremely difficult to ascertain.

C. *Post-July 1, 1978 Clauses*

The legislature, as part of a comprehensive revision of the law relating to liquidated damages, repealed Civil Code section 1670 and amended section 1671, operative July 1, 1978. The general approach was to leave “consumer” type contracts subject to the stiff constraints originally imposed on liquidating damages, but to allow liquidation on a more liberal basis for “non-consumer” type contracts.

A residential lease (for use as a dwelling by the party or those dependent upon the party for support) comes within the “consumer” category and will remain subject to the strict requirements discussed above in connection with the pre-July 1, 1978 clauses.⁹¹

A non-residential lease provision liquidating damages, however, “is valid unless the party seeking to invalidate the provision establishes

90. *Garrett v. Coast & S. Fed. Sav. & Loan Ass'n*, 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

91. CAL. CIV. CODE § 1671(c)(2), (d) (West Supp. 1978).

that the provision was unreasonable under the circumstances existing at the time the contract was made.”⁹² Note how the emphasis shifts from “void except” in a residential lease to “valid unless” in a non-residential lease. The opponent has to establish unreasonableness and must do so on the basis of the circumstances existing at the time the contract was made. The report of the California Law Revision Commission which generated this new legislation states that unreasonableness should not be judged by hindsight, and to permit consideration of damages actually suffered would defeat a primary purpose of liquidation, the avoidance of litigating the amount of actual damages.⁹³ This liberalization for non-residential leases does not mean there is now a license to fill in the blank with whatever the traffic will bear, but it does give protection to realistic attempts to liquidate.

Despite the general liberalization of the liquidation requirements, the lease drafter must give consideration to the specific type of damages in a non-residential tenancy that would be suitable for liquidation. For example, are damages based on the rent obligation suitable for liquidation?

The old cases that discouraged liquidation by imposition of the impracticable/extremely difficult test were decided within the framework of Lessor remedies that existed prior to the substantial revision of remedies in Civil Code sections 1951.2 and 1951.4, operative July 1, 1971. The pre-July, 1971 rent related remedies for a breach or abandonment were basically the following:⁹⁴

1. The Lessor could leave the lease in effect and sue for the rent as it accrued. If the premises had been abandoned by the Tenant, the Lessor had no obligation to mitigate damages and could leave the premises vacant.
2. The Lessor could leave the lease in effect and relet the premises to another Tenant “on behalf of” the breaching Tenant. The deficiency resulting from collecting less rent on reletting than the rent agreed to by the breaching Tenant could be collected at the end of the original term.
3. The Lessor could terminate the lease and retake possession on his own behalf. The Lessor could collect rent that accrued before termination. However, subject to an exception noted below, the Lessor could not collect any damages based on post-termination losses in rent.

92. *Id.* § 1671(b).

93. 1976 ANNUAL REPORT, *supra* note 87, at 1742.

94. CALIFORNIA LAW REVISION COMMISSION, RECOMMENDATION AND STUDY RELATING TO ABANDONMENT OR TERMINATION OF A LEASE, 8 CALIFORNIA LAW REVISION COMMISSION REPORTS, RECOMMENDATIONS, AND STUDIES 702, 707-08, 743-62 (1966).

For example, suppose the lease had three years to run when terminated and the lease provided for rent of \$1,000 per month. If the Lessor could only get \$900 per month upon reletting, the loss of \$100 per month for thirty-six months was not recoverable from the breaching Tenant.

With each of these three remedies, the rent or rent-based damages would have been subject to relatively easy calculation and proof if a fixed rent lease was involved. Hence, the damages would not have been impracticable or extremely difficult to ascertain. Suppose, however, that the Lessor could terminate the lease and collect post-termination prospective damages, based on the difference between the agreed rent and the amount of rent which the Lessor could reasonably produce from the premises in the future over the balance of the lease term. Suppose also that the terminated lease provided for percentage rent based on the business generated from the Tenant's use of the premises. Under these circumstances, the determination of damages would depend upon predicting the future rental value of the premises and predicting what the productivity of the Tenant's business would have been in the future if there had been no breach. As the need for clairvoyance increases, so does the degree of difficulty in determining actual damages, particularly when several years of the lease remain at the time of termination.

Although post-termination damages were available prior to July 1, 1971 by special lease provision,⁹⁵ the adoption of the comprehensive remedy legislation which became operative on that date has increased the attention given to prospective damages, and provided for the recovery of such damages even absent a lease clause in certain circumstances.⁹⁶ It seems that these damages, particularly in percentage rent leases and long term leases, are suitable for liquidation.

Another example of a situation in which liquidation of rent-related damages would seem suitable is a Tenant's abandonment of premises held under a percentage lease. The 1971 legislation provides that, subject to certain requirements, the Lessor can leave the lease in effect, leave the premises vacant, and "recover the rent as it becomes due."⁹⁷ If the Tenant has abandoned and has not made any effort to sublet or assign to another operator, the Lessor's right to recover rent as it comes due in the future involves the problem that there is no existing business upon which percentage rents can be calculated. Liquidating damages

95. CAL. CIV. CODE § 3308 (West Supp. 1978).

96. *Id.* § 1951.2.

97. *Id.* § 1951.4.

flowing from the Tenant's failure to operate would seem appropriate in such a situation.

The liberalized test for liquidated damages in non-residential leases and the suitability of a particular class of damages do not assure the enforceability of a liquidation provision. There must be some reasonable basis for the specified amount of liquidated damages. For example, consider a "one form fits all" type clause that provides: "If Tenant breaches this lease, Lessor shall be entitled to \$10,000 as liquidated damages, the actual damages being impracticable and extremely difficult to ascertain." This seems unreasonable on its face. It lumps together all breaches, regardless of type or severity, it makes no distinction based on whether the lease is terminated or continued in effect, and it makes no distinction based on the time remaining at the time of breach. The only apparent advantages of such a clause are that it takes little space and even less energy. The drafting of a liquidated damage clause should take into consideration the type of breach, the type of damages being liquidated, the type of remedy involved (*e.g.*, termination or continuation of the lease), and the duration of the lease term remaining at the time of breach. It is particularly important to consider the balance of the term remaining when rent-related damages are involved. If, for example, the lease has a twenty-year term, a lump sum of liquidated damages ignores that a breach and termination in the first year would produce substantially different damages than a breach and termination in the nineteenth year. The damages could be liquidated by drafting a formula with an agreed factor or factors being multiplied by the number of months remaining in the term.

A late payment charge is another common example of the problem of a reasonable basis for the amount of liquidated damages. Recent California decisions have treated a late payment charge as an attempt to liquidate damages, subject to liquidation requirements.⁹⁸ In *Garrett v. Coast & Southern Federal Savings & Loan Association*,⁹⁹ the court struck down a loan late payment charge of two percent of the loan balance because it was not reasonably calculated as fair compensation to the lender. The court pointed out dual purposes served by a late charge: to compensate the lender for administrative expenses and cost of money withheld; and to "encourage" the borrower to pay on time. If such a charge is designed to substantially exceed damages, it is an attempt to compel timely payment by the threat of a penalty that lacks a

98. *Crestwood Library Co. v. Citizens Sav. & Loan Ass'n*, 83 Cal. App. 3d 819, 148 Cal. Rptr. 129 (1978).

99. 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973).

reasonable relationship to actual losses. Even though liquidated damages may still be valid when they have the incidental consequence of encouraging good conduct,¹⁰⁰ if there is no reasonable endeavor to determine an amount with a reasonable relationship to the potential actual damages, the provision is a void penalty. Another important point made by the *Garrett* court is the distinction between "extreme difficulty" and "impracticable." Although it was not necessary to determine the issue, the court pointed out that even though it may not be extremely difficult to determine actual damages, it may be impracticable to do so. This is particularly true with late charges, where the actual damages would be comparatively small, but it would be economically impracticable to prove actual damages in each instance of default in timely payment.

Drafters of late payment charges may find some guidance, by analogy, in the legislation governing late payment charges in loans on single-family, owner-occupied dwellings.¹⁰¹ Consider, however, that even though it is theoretically possible to draft and enforce a late payment charge on rent, it may not make practical sense for a Lessor to try to enforce it when possession is sought in an unlawful detainer action. The preliminary three-day notice to pay rent or quit must set forth the amount due.¹⁰² When a late charge is included in the amount due, is it worth the potential delay and expense of litigating the validity of liquidated damages? Would the Lessor be better off settling for interest? Consider, for example, that the trial court might sustain a demurrer to the unlawful detainer complaint on the basis that the demand in the preliminary notice was excessive.¹⁰³ Do not pass go, do not collect \$200.¹⁰⁴

The format of a liquidated damage clause should be given some consideration. New legislation, concerning liquidated damages in a residential property purchase contract, requires that the provision be separately signed or initialed, and, if in a printed form, that it be a certain size type.¹⁰⁵ Although the format requirements do not appear to apply to tenancies, it might be a good drafting technique to follow

100. *Lowe v. Massachusetts Mut. Life Ins. Co.*, 54 Cal. App. 3d 718, 127 Cal. Rptr. 23 (1976).

101. CAL. CIV. CODE § 2954.4 (West Supp. 1978).

102. CAL. CIV. PROC. CODE § 1161.2 (West Supp. 1978).

103. *Kirby v. Mann*, 7 CLEARINGHOUSE REVIEW 685 (San Mateo County Muni. Ct. Nov. 15, 1973).

104. See *Monopoly, Parker Bros., Inc.*, 1936.

105. CAL. CIV. CODE § 1677 (West Supp. 1978).

them anyway. They demonstrate a conscious attention to the liquidation of damages.

V. OTHER FACTORS

This article has focused primarily on the refundability of front end payments, to the extent the payment exceeds the amounts due to, and damages suffered by, the Lessor. In the structuring of a front end payment, consideration should also be given to other factors which might have an impact. A couple of examples of such factors will be dealt with here.

A. Income Tax Treatment

The treatment of a front end payment, for income tax purposes, will vary depending on the type of payment involved. In a non-residential lease, where a substantial payment is more likely to be involved, the choice of payment type can have a significant impact. There are several sources for a detailed discussion of the tax ramifications,¹⁰⁶ so only a brief summary is necessary here.

The payment of a refundable security deposit has no immediate tax consequences. It is neither income to the Lessor, nor a deduction for the Tenant. If it is later returned to the Tenant, no tax consequences occur. If it is later applied to a rent default, however, it is income to the Lessor and a deduction for the Tenant at the time of application. When the security is applied to breaches other than rent, the tax treatment varies, depending on the type of breach. A provision for application of the security deposit to future rent runs the risk of treatment as an advance payment of rent for tax purposes.

An advance payment of rent is considered as income to the Lessor upon receipt, regardless of whether the Lessor is on a cash or accrual method of accounting. However, the Tenant cannot deduct the payment until the arrival of the period or periods for which the payment has been designated. If no specific period has been designated, the payment must be amortized over the lease term by the Tenant.

A bonus or consideration for execution is income to the Lessor upon receipt, and the deduction available to the Tenant must be amortized over the lease term.

When a payment is required to be amortized over the lease term by

106. *See, e.g.*, CALIFORNIA CONTINUING EDUCATION OF THE BAR, COMMERCIAL REAL PROPERTY LEASE PRACTICE §§ 4.32-4.35, 5.10; ANDERSON, TAX FACTORS IN REAL ESTATE OPERATIONS 284-86 (4th ed. 1976).

the Tenant, the period of an option to extend or renew must generally be included, unless certain limited exceptions are present.¹⁰⁷

The tax treatment of a security deposit seems to be based on the fact that the Lessor does not have an unqualified right to keep the payment since it must be refunded to the extent it exceeds amounts due to, or damages suffered by, the Lessor. If California is going to disregard the labels of advance payment of rent, and bonus or consideration for "execution," and subject these payments to refund to the extent they are unearned (reference sections III.A.5. & III.B.3. above), it seems that the tax treatment accorded to these payments should be reevaluated.

B. Deed of Trust Sale or Foreclosure

A Tenant making a substantial front end payment has reason to be concerned if the lease will be subordinate to a trust deed. This subordinate position would occur either where the trust deed encumbers the property prior to the lease or where the lease requires the Tenant to subordinate his interest to a subsequent trust deed given by the Lessor. If the trust deed has priority and there is a trustee's sale or foreclosure, the lease will be subject to termination¹⁰⁸ and the Tenant will be at the mercy of the buyer at the sale. The Tenant can try to work out a deal with the buyer, but unless the continued tenancy is very favorable to the buyer, the Tenant will be in a poor position to bargain. If the lease is terminated, the Tenant will lose the right to future possession and the benefit of his front end payment.

Although the Tenant can proceed against the Lessor for breach of quiet enjoyment by reason of eviction by the paramount interest,¹⁰⁹ in many cases the judgment can just be placed in the Tenant's scrapbook of fond memories. If the Lessor does not have the money to prevent default on the trust deed note, he will probably be in a poor position to respond in damages.

When there is an existing trust deed, the Tenant can try to work out protection with the lender before the lease is executed and the front end payment made. He can try to get the lender to agree to subordinate the trust deed to the lease. Another alternative would be to try to get a "Nondisturbance Agreement" from the lender, with the lender agreeing to recognize the Tenant's continued right to possession, and credit for front end payments made pursuant to the lease. If the lease appears favorable to the lender, and the lender covets the cash flow generated

107. I.R.C. § 178.

108. *McDermott v. Burke*, 16 Cal. 580, 589-90 (1860).

109. CAL. CIV. CODE § 1927 (West 1954).

from the lease, the Tenant will have some bargaining power with the lender. Otherwise, the Tenant will come away empty-handed.

When the Tenant is faced with a lease provision requiring subordination to future trust deeds by the Lessor, the Tenant should think long and hard about the sweetheart of a deal he is getting into. Perhaps the Tenant can require a "Nondisturbance Agreement" from the lender as a condition to subordination. Again, his bargaining power will determine success in eliminating or qualifying the subordination clause.

Consideration should also be given to placing the front end payment in a trust or escrow with provision for refund to the Tenant in the event of a trustee's sale or foreclosure.

VI. CONCLUSION

The conclusion to an article generally seems more modest than its introduction. The expectations generated at the beginning give way to the hope at the end that some point has been made in between.

The point here is that there are various ways a front end payment can be structured, and the choice has important ramifications. The true nature of the payment, rather than labels, should determine those ramifications, particularly with regard to refundability upon premature termination of the tenancy. In negotiating or litigating a front end payment, there must be a sensitivity to the true nature of the payment, the background cases, the statutory modifications, and the remaining questions and ambiguities requiring legislative or judicial attention. Front end payments in California have been like donuts—some substance and some plain air. As you wander through front end payments, whatever be your goal, keep your eye upon the donut and not upon the hole.