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Landlords entitled to setoff security deposit after expiration of statute of limitations

By Sandra D. Berzups

In the class action *Granberry v. Islay Investments*, 889 P.2d 970 (Cal. 1995), the California Supreme Court *en banc* held that landlords were entitled to automatically setoff security deposits against unpaid rents, cleaning, and repair costs even when the landlords, in good faith, failed to return security deposits to tenants within a certain time period as mandated by statute. However, if the security deposit is not returned within three weeks of the tenancy termination date, the landlords must prove that such damages were suffered by a preponderance of evidence at an evidentiary hearing. The court remanded the case for the trial court to reconsider the choice of remedy for distributing wrongfully withheld deposits and for assessing attorney's fees.

Excess fees above rent are considered a security deposit

From 1978 to 1981, Islay Investments ("Islay"), the owners and operators of 1200 residential rental units in the Santa Barbara area, added approximately \$100 to tenant rental fees for the first 31 days of tenancy, which aggregated to a total of \$1 million. Islay never returned this fee to the tenants nor gave written accountings for the retention on the basis that such fee constituted a part of the first month's rental payment. A class of former tenants sued for a refund of this amount.

California landlord-tenant law provides that a landlord must return the security deposit paid by a former tenant within three weeks after the termination of tenancy and provide a written accounting of any portion retained as compensation for unpaid rent, repairs, and cleaning. The purpose of the statute, especially Section 1950.5, was to ensure the speedy return of security deposits upon the termination of tenancy and to prevent the improper retention of such deposits. The district court determined that this section did not apply because the increased rent paid in the first month was in fact rent and not a security deposit. The court of appeals reversed,

stating the character of the supplemental payment was a triable issue of fact.

On remand, Islay argued that it was entitled to setoff amounts for unpaid rents, cleaning, and repair if the increased rental payments were deemed a refundable security deposit. The trial court found that the excess rental payments were indeed security deposits within the meaning of Section 1950.5, but that Islay did not have the right to setoff due to its failure to return such amounts in a timely manner. The court awarded costs and attorney's fees to plaintiffs, which would be recovered from the aggregate amount to be paid by Islay, not to exceed 25 percent. Upon appeal, the court of appeals ruled that the trial court erred in denying Islay the right to setoff. However, the trial court did not abuse its discretion in limiting costs and attorney's fees to 25 percent and in granting refunds only to those class members who came forward to claim them. The California supreme court granted certiorari to resolve the issue of whether the landlords had the right to setoff, notwithstanding their good-faith lack of compliance with Section 1950.5.

Landlord's right to setoff spelled out

Upon analysis of 1950.5, the court concluded that when the landlord did not provide a timely written accounting of the retained portion of the security deposit, the landlord must return the entire deposit to the tenant. Islay asserted that because the legislature provided a remedy only for bad faith retention of a security deposit, landlords that retain security deposits in good faith should not be penalized by being barred from retaining setoff. The plaintiffs countered that this result would be inconsistent with principles of equity and public policy because a landlord may use such a defense to keep all or part of the security deposits and profit from its own wrong in violation of Section 1950.5. The plaintiffs further contended that setoff would be inappro-

priate in a class action due to numerous practical difficulties associated with the size of the class and the relatively small amount involved per claim.

In view of these arguments, the California supreme court affirmed the court of appeals' judgment. The court concluded that although the landlord failed to avail itself of the deduct-and-retain procedure, all its other rights to claim damages in an evidentiary hearing could not be denied so long as the landlord has met the burden of proof as to the reasonableness of the amounts claimed. The court reasoned that this burden is sufficiently great, especially with the lapse of time, so as not to allow the landlord to profit from his own wrong. The court also noted that Islay should not be deprived of its substantive rights to meet this burden of proof due to the litigation posture the class-action plaintiffs took. The court also stated that on remand it may be possible to shape a remedy that will avoid many of the problems the plaintiffs have identified as well as to determine whether defendant's claims are barred by any of the generally applicable equitable affirmative defenses of laches, unclean hands, and estoppel.

Fluid recovery method considered to compensate tenants

The trial court originally determined that the fluid recovery method should be used to compensate the entire class for the landlord's retention of the excess rental payment. The implementation of this method involves three steps: (1) defendant pays total liability into a class fund; (2) individual class members collect the damages they can prove; and (3) the fund distributes any excess "by one of several practical procedures developed by the courts." The court noted that the trial court on remand must reevaluate whether the fluid recovery method is appropriate in light of the forthcoming evidentiary hearing on defendants' claim of setoff. In addition, the trial court will need to determine whether attorney's fees in the amount of 25 percent of the

aggregate class recovery is adequate when the amount of defendants' offsets have not been calculated.

Dissent criticizes landlord's setoff rights

In a separate dissenting opinion, Justice Kennard disagreed with the majority's interpretation that the language of Section 1950.5 did not bar setoff claims against security deposits in subsequent actions by the tenant, even when the statutory period to deduct-and-retain had lapsed. Justice Kennard stated that the plain language of Section 1950.5 provides that the landlord should forfeit any and all rights to setoff claims against the security deposit if the landlord does not do so within the statutory period. He opined that the legislative history behind 1950.5 was meant to level the playing field between the tenant, who often faced insurmountable obstacles to file a claim, and the recalcitrant landlord who often had the upper hand in such a relationship. In effect, by telling the landlord, "claim it or lose it," Justice Kennard suggests that if a landlord wishes to pursue recourse after the statute of limitations has expired, he still is able to do so in an independent suit against the tenant. In addition, he contended that a limitations period for asserting claims and right to setoff should not be construed as a penalty, but, rather a necessity by implication for any statutory violation which includes improper retention of security deposit accompanied by bad faith.

Finally, Justice Kennard disagreed with the trial court's limitation on the landlord's liability to only the amounts owed to those class members who may come forward and submit individual claims. He contended that the proper measure of the class recovery is the landlord's total liability to the entire class, not merely the amounts that individual class member may step forward to claim. In effect, Justice Kennard concluded that the trial court narrowed the class without notice by extinguishing the causes of action of non-claiming class members.
