

Where did I put my key (money)?: If It's Not in the Lease It's not Enforceable

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The market for nursing facility beds in California is at historic highs with the price per bed currently ranging from \$80,000 - \$100,000. For owners wishing to retain the asset but not remain directly involved in operations, leasing facility beds also presents an attractive option right now with beds currently leasing out in the Southern California area for anywhere between \$500-600/bed per month.

In the context of leasing, in addition to the rental rate most landlords will

require “key” money as a condition of the lease. Key Money is a form of payment made by the tenant to the landlord not included in rent which compensates the landlord for giving the tenant the keys to the commercial property. The legal basis for supporting the enforcement of key money obligations relates to the concept of goodwill in that the landlord is turning over a going concern for the tenant to operate. In other words, the landlord is transferring a viable operating business to the tenant which has an intrinsic value the tenant pays for in the form of key money. Currently, key money paid in connection with nursing home leases can vary from as much as \$10,000 - \$14,000/bed.

In requiring key money as a condition of the lease, landlords (and tenants) must be aware of California Civil Code Section 1950.8 which requires that key money or other amounts required as of a condition of a commercial lease or non-residential lease of real property must be stated in the lease agreement. Subsection a provides:

It shall be unlawful for any person to require, demand or cause to make payable any payment of money, including but not limited to, key money, however demanded, ...as a condition of initiating, continuing, or renewing a lease or rental agreement, unless the amount of payment is stated in the written lease or rental agreement.” Penalties for violating this provision include a civil penalty of up to 3 times the amount of damages suffered by the prospective tenant as well as recovery by the tenant of the attorney fees it incurred in enforcing the provision. (Subsection c.) The policy underlying the statute is to eliminate under-the-table pressure tactics used by some landlords of requiring cash payments of key money that are not documented in the lease. See, *Edamerica, Inc. v. Superior Court* (2003) 114 CA4th 819.

Exceptions to the provision allow the landlord and tenant to agree to the advance payment of rent, the landlord may charge reasonable amounts for “conducting reasonable

business activity in connection with initiating, continuing or renewing” the tenancy, and the landlord may increase the rent to recover building operating costs if the right to rent, the method of calculating the increase, and the time period covered by the increase are stated in the lease or rental agreement. (Subsections d-f.)

The consequences of violating the provision seem clear: If the key money is not stated in the lease or rental agreement the obligation is not enforceable and the landlord would face significant liability if it nonetheless sought to enforce an “obligation” not stated in the lease. On the other hand, compliance does

create some interesting questions. Apart from the statutory mandate (which is controlling), why would key money be included in a lease since it is not a requirement of the leasehold? As mentioned, the lease payments are consideration for the lease; key money is consideration for “buying” the business. For taxation purposes, if key money is properly allocated to the business, should that allocation appear in the lease or an ancillary document, which raises additional questions. Many nursing home lease transactions are documented outside of the actual lease document in ancillary documents sometimes referred to as a Memorandum of Understanding or a Letter of Intent.

What if key money is referenced in these documents but not in the lease itself? It would appear that doing so would address the concerns stated by the court by eliminating strong arm tactics by landlords. But is an MOU or LOI a rental agreement covered by the statute?

So while there may be good business reasons to deal with key money issues in ancillary documents, and while it may be expedient to do so from the perspective of drafting, buyer beware...or more to the point, landlord beware. If not in the lease, key money provisions are unenforceable and illegal.

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