HANDLING TENANT DEMANDS FOR SECURITY DEPOSIT REFUNDS

Security deposit issues consistently arrive at the THS situation desk. If you are in the rental industry, you must have a solid understanding of security deposit law. Because not everyone had the opportunity to attend our recent security deposit class at the AAMD trade show, this month we share the tenant security deposit demand portion of the class.

Before discussing tenant security deposit demands, let's briefly review security deposit basics. A security deposit is defined as any sum of money (no matter what you call it, e.g. last month's rent) whose purpose is to secure performance of a lease. When a tenant moves out, you must account for the tenant's security deposit. If you don't return the full deposit, then you must account for, i.e. provide the exact reasons why you kept all or any portion of the security deposit. You have to provide the accounting within 30 days of when the tenant moves out or when the lease terminates, whichever is later. You can extend the accounting period up to 60 days by agreement in your lease.

If you fail to provide the accounting by the deadline, you forfeit all rights to withhold any portion of the security deposit. If a tenant disagrees with your security deposit accounting, the tenant has the right to sue you. If the court finds you shouldn't have withheld the security deposit, or any portion of it, the court can (almost certainly will) award the tenant 3 times the amount of the security deposit wrongfully withheld, plus the tenant's attorneys' fees and costs. However, before a landlord is liable for 3 times the security deposit and the tenant's attorneys' fees, the tenant has to give the landlord one last opportunity to return the deposit. Specifically, when a tenant demands return of a security deposit, a landlord has one last chance to avoid treble damages and attorneys' fees by returning the deposit within 7 days.

None of the rights and obligations discussed, in this article, can be altered by your lease. The Colorado Security Deposit Act specifically prohibits this. The statute specifically provides that any lease provision or other agreement which attempts to alter or waive a tenant's security deposit rights is void.

Now that we have reviewed the statute's key points, let's discuss the biggest security deposit mistake that we see. The biggest mistake landlords make is dropping the ball when a landlord gets a 7-day security deposit demand. While the demand doesn't have to be in writing, 99.9% of all security deposit demands are made in writing. The tenant makes the demand in writing because they want to be able to prove to the court that the demand was made. Under the statute, the landlord gets 7 calendar days to respond to the demand. Unfortunately, we frequently receive tenant security deposit demands well past the 7-day deadline.

Blowing the 7-day deadline can have severe repercussions, limit the landlord's options, and in many instances makes a bad situation worse. If the deposit was $500 and you blow the deadline, the tenant may want (probably will want) $1,500 now instead of the original $500. The deadline is missed for a host of reasons including inadvertence and failure to appreciate the significant risks of not evaluating the situation and refunding within 7 days. Landlords minimize

the risk because landlords wrongfully conclude that there is no risk associated with a tenant security deposit demand, if the tenant owed money on move-out. However, even if the tenant owed a balance at move-out, depending on the facts of the case, the landlord could be facing a tremendous financial downside.

Operationally, landlords must be able to evaluate security deposit demands within 7 days, including responding to the demand and refunding the security deposit when appropriate. If the best tactical move is to refund, you have to have the check in the mail within 7 days to prevent the tenant from holding your feet to the fire for 3 times the original deposit. Countless clients have found themselves in a bad security deposit situation even though they timely made the right decision (evaluated the demand and decided to refund within the 7 days), because they could not get a check from corporate out the door within the 7-day period. Operationally, you have to be able to produce and get a check in the mail by the deadline.

Failure to evaluate and deal with a $500 security deposit can potentially turn into a $6,000 to $7,000 loss. As mentioned, once the deadline is blown, the tenant now wants $1,500 to settle. The landlord was reluctant to refund the $500 so there is no way the landlord is going to pay the tenant $1,500. The result is that the landlord digs in, and the tenant sues. The court finds that the tenant wasn't entitled to a full refund of the $500 security deposit, but should have been refunded $250 of the deposit. The $250 gets trebled, so know the landlord owes the tenant $750.

But this is only the beginning. If you have been around the security deposit block a time or so, you know that attorneys' fees are a critical component of security deposit litigation analysis. Under the statute, you pay the tenant's attorneys' fees if you lose. In addition to the $750 security deposit judgment, the court awards the tenant $4,000 in attorneys' fees. This probably would be the minimum a tenant's attorney would request. In addition, if you pay us to defend you, this is another $2,000 for our attorney fees, so your total liability is now $6,750.

Nearly a $7,000 loss because the landlord was trying to hold onto a $500 deposit. It goes without saying this is an extremely poor gamble (risk-reward decision). To put it in perspective, let me ask you this: would you place $7,000 on the table in Las Vegas to win $500? Unfortunately, too many landlords don't evaluate the risk or aren't capable of evaluating the risk within the 7-day demand period. Invariably, this nightmarish scenario gets put in motion because the landlord didn't or couldn't evaluate the security deposit demand within the 7-day period. Did I mention how critical it is to be able to evaluate and respond to a security deposit demand within the 7-day period?

Too frequently landlords get hung up on the MOS (move-out statement). Specifically, clients frequently tell us that they did evaluate the situation, and their evaluation is the MOS. In other words, they are going to play the cards they dealt themselves (the MOS). This thinking is short-sighted. This thinking ignores the key purpose of evaluating (reevaluating) a MOS after receiving a security deposit demand.

The key purpose of reanalyzing a MOS is to determine the risk of any line item being lost in court, and what the net effect on the total balance is if that item is lost. Because the judge will review the MOS line by line in a security deposit suit, you should take another hard look at the

MOS from a court's perspective. Some line items on a MOS are more likely to withstand scrutiny in court than others. Back rent is strong and will always withstand judicial review. On the other hand, a two-month lease break fee when you re-rented a week later could easily go against you. Based on the amount of the security deposit and the MOS balance, can a few lost line items put you on the wrong side of $0? If you are on the wrong side of $0 in a security deposit case (meaning you owe the tenant money), the verdict will be for the tenant.

While it would be much easier to illustrate with the spreadsheet handout I used at the tradeshow, a simple example will suffice. A tenant with a $500 security deposit has a MOS that shows he owes the property a final balance of $250. The tenant's MOS has 22 line items, but we will only concern ourselves with 2 of the charges. The landlord charged the tenant a $280 dumpster fee and $300 for damaged carpet. If the landlord loses either one of these charges, or both, the landlord is going to go from being owed $250 by the tenant, to owing the tenant money. For example, if the landlord loses the carpet charge, the landlord now owes the tenant $50 ($250 - $300 = -$50). If the landlord owes, then part or all of the deposit should have been refunded and the tenant wins the case.

OK, we get it. We have to evaluate a security deposit demand within 7 days and respond. But why should we refund the security deposit or any money for that matter if the tenant owes us money? You should refund in many security deposit scenarios because it minimizes your risk while preserving your rights. Most landlords, owners, and management companies do not know the secret. The little-known secret is that refunding a tenant's security deposit doesn't mean that the tenant doesn't owe you the money or have to pay it. Specifically, under Colorado law, a landlord may refund a security deposit but still collect the balance owed by the tenant.

For example, if the tenant owes the landlord a $1,000 balance and demands the refund of a $250 security deposit, the landlord can refund the $250 security deposit and still attempt to collect the $1,250 owed ($1,000 + the $250 refunded which had been previously credited on the MOS). Refunding does not waive the landlord's right to collect any balance. What refunding does do is change the entire dynamic of the dispute. When the deposit is refunded, the landlord no longer faces a potential $7,000 loss over a security deposit claim. With no potential security deposit liability, the tenant will have a much more difficult time getting an attorney interested in their case. Simply put, the landlord goes from defense back to offense by refunding the deposit.

Remember, in order for a refund to eliminate liability under the Colorado Security Deposit Act, the refund must be mailed prior to the expiration of the 7-day demand period. Security deposit refund checks should always contain a restrictive endorsement that the check is being paid under protest While you are issuing the refund, you do not agree with the tenant's right to the payment (assuming that they owe you money). We also recommend accompanying the refund with a letter that states you do not agree with the tenant's right to the refund, the payment is being made under protest to avoid liability under the Colorado Security Deposit Act, landlord is not waiving its rights to collect money owes, and the collection of such monies will be pursued.

Sometimes you don't even need to evaluate the MOS to determine that you should refund. For example, management companies may want to deploy a playing the percentage

strategy. If you adopt this strategy, you always refund when you get a security deposit demand letter. A 400-unit community with 100 turns a year illustrates the strategy. If the security deposit is $500 and all residents owed $500 or more at move-out, the community would retain $50,000 in security deposits. If 10 tenants demand return of the $500 and the community returns all 10 deposits, the community is temporarily out $5,000 (remember the community can still try to recover these write-offs even though the deposits were returned).

If the community doesn't return the 10 deposits and loses just 3 out of the 10 cases, the community could potentially be out $21,000 (3 x $7,000 loss in each case). By trying to fight 3 cases, the community's bottom line on the deposits is $29,000 ($50,000 - $21,000 lost in security deposit litigation). If the community had deployed a playing the percentages strategy, the community's bottom line would be $45,000 ($50,000 - $5,000 worth of refunds). The community would still have the opportunity to recoup the $5,000 worth of payouts in collections.

Landlords should always refund the security deposit under some circumstances. If you failed to account by the deadline, you must refund. If you don't, be prepared to write a big check. Remember, legally, you forfeit any right to withhold the deposit if you miss the accounting deadline. You should always refund if you can't evaluate the demand within the 7-day period (better to be safe than sorry). We recommend refunding any deposit under $300, or an amount that you determine. This avoids risking a large loss to retain a small amount. If you can't document the condition of the unit at move-in or move out, you should refund. Similarly, if you are not confident that you can prove physical damages (evidence lost or no witnesses), you should refund.