Washington Law Review

Volume 30
Number 3 *Washington Legislation-1955*

8-1-1955

Lease Deposits in Washington

John T. Piper

LEASE DEPOSITS IN WASHINGTON

JOHN T. PIPER

When a lessee deposits with his lessor a sum of money under an agreement that the lessor will return it or apply it in a specified manner if the lessee fully performs his covenants, at least three legal problems may arise. First, in the event that the tenant fails to give full performance, how much of the deposit can the landlord keep? Second, is the obligation of the landlord to return or otherwise apply the deposit a covenant running with the land? Third, when does the landlord pay taxes on the deposit?

How much of the deposit can the landlord retain in the event of breach by the tenant?[1]

Both the question and the applicable principles of law are fundamentally the same in all types of contracts, and the Washington court does not distinguish between leases and other types of contracts in citing authority. In this Comment reliance will be placed upon cases involving other types of contracts where the court has done so, but for convenience the scope will be confined to the problem of deposits in lease agreements.

A deposit made as *liquidated damages* is to be retained by the lessor in lieu of performance; thus in the event of breach *the lessor may keep the whole deposit.*[2] Such a deposit is made where there is likely to be an uncertainty of or a difficulty in ascertaining actual damages.[3] A deposit made merely as *security* for performance will be treated as a penalty and *recovery limited to the actual damages caused by the breach.*[4] The importance of the distinction is obvious.

[1] There are only two answers to the question of how much of the lease deposit the landlord may keep in the event of a breach by the tenant; either he can keep it all or he can keep it only to the extent that he was damaged by the breach. But the scarcity of alternatives has not made the question easy to answer. The Washington court has recently noted the fact that the law relative to the problem of deposits in general was in a state of great uncertainty more than a century ago and that "the intervening years and decisions have not resolved, but have compounded it." Management, Inc. v. Schassberger, 39 Wn.2d 321, 327, 235 P.2d 293, 297 (1951).

[2] Wilbur v. Taylor, 154 Wash. 282, 291, 282 Pac. 65, 68 (1929). The court quoted with approval from 17 C.J. 933, 934, 935.

[3] Madler v. Silverstone, 55 Wash. 159, 165, 104 Pac. 165, 167 (1909); Barrett v. Monro, 69 Wash. 229, 232, 124 Pac. 369, 370 (1912); Mosler v. Woodell, 189 Wash. 583, 587, 66 P.2d 353, 355 (1937); Smith v. Lambert Transfer Co., 109 Wash. 529, 532, 187 Pac. 362, 363 (1920); Benjamin Franklin Thrift Stores v. Jared, 192 Wash. 252, 256, 73 P.2d 525, 526 (1937); Management, Inc. v. Shassberger, 39 Wn.2d 321, 328, 235 P.2d 293, 297 (1951).

[4] Wilbur v. Taylor, 154 Wash. 282, 291, 282 Pac. 65, 68 (1929).

Two factors, operating separately or jointly, depending upon the facts of the particular case, apparently determine the nature of the deposit: (1) the intent of the parties; (2) the policy of the law. The intent of the parties will control unless it its contrary to a policy of the law in which case the policy will control.[5] To determine what the intent of the parties and the policy of the law are in a particular case, the court looks to four criteria singly, and in combination, depending upon the facts of the case:[6] (1) the meaning of descriptive words and language used by the parties; (2) the reasonableness of the stipulated sum in relation to probable damages; (3) the uncertainty of or difficulty in ascertaining actual damages; (4) the variation in the importance of the covenants and in the amounts of damage likely to result.[7]

The court has recently declared that the descriptive words[8] used by the parties are not necessarily controlling or conclusive as to the intent of the parties,[9] and has previously so held in two cases involving contracts.[10] As it happens, in cases involving leases, except where the parties have used words descriptive of both liquidated damages and security,[11] the court has found the nature of the deposit to be exactly what the parties have designated it;[12] this indicates that a designation

[5] Smith v. Lambert Transfer Co., 109 Wash. 529, 531, 187 Pac. 362, 363 (1920). In this leading case concerning lease deposits the court indicates that the agreement will be given the legal force that the intent of the parties calls for unless the agreement is against the policy of the law. But in its discussion the court appears to confuse and merge the two factors so that the exact application of each factor is difficult to determine from the language of the opinion. A much clearer statement is quoted with approval from a leading case involving a contract for the exchange of realty. Madler v. Silverstone, 55 Wash. 159, 165, 104 Pac. 165, 167 (1909). See also 1 RESTATEMENT, CONTRACTS 552, § 339.

[6] See 106 A.L.R. 292 for a discussion of the principles used by courts generally.

[7] These principles are clearly set out in Madler v. Silverstone, 55 Wash. 159, 104 Pac. 165 (1909).

[8] Words such as "liquidated damages," "security for performance," "indemnity," etc.

[9] Management, Inc. v. Shassberger, *supra* note 3, at page 531, the court citing from Smith v. Lambert, *supra* note 3.

[10] Erickson v. Green, 47 Wash. 613, 92 Pac. 449 (1907); Stoner v. Shultz, 69 Wash. 687, 125 Pac. 1026 (1912).

[11] Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362 (1920), where the lease provided that the deposit was "in payment of the last several monthly installments of rental," and "as security to said lessors for the faithful performance of the covenants and agreements on the part of the lessee" and that the deposit, in case of default, "shall be forfeited as liquidated damages by the lessors."; Benjamin Franklin Thrift Stores v. Jared, 192 Wash. 252, 73 P.2d 525 (1937), where the deposit was "paid by the lessee as security for the faithful performance of the terms of this lease" but in the event of breach the lessor was to "retain said sum of forty-five dollars as liquidated damages."; Munson v. Baldwin, 88 Wash. 379, 153 Pac. 338 (1915), where the lease provided that the deposit should be paid "as security guaranteeing the performance of this lease," but in the event of breach should "be retained by the lessors on account of liquidated damages."

[12] Excluding the cases falling under the doctrine of Dutton v. Christie, 63 Wash. 372, 115 Pac. 856 (1911), discussed *infra*, the court has upheld the designation of the parties in Martin v. Siegley, 123 Wash. 683, 212 Pac. 1057 (1923); Stern v. Green, 127 Wash. 429, 221 Pac. 601 (1932); Wilbur v. Taylor, 154 Wash. 282, 282 Pac. 65 (1929);

by the parties carries weight. Nevertheless, the court's declaration that descriptive words used by the parties are not necessarily conclusive as to the intent of the parties has support in the cases.[13]

Assuming that the court will not regard descriptive words alone as controlling on the issue of intent of the parties, is there any language which can be used by the parties which will foreclose the question of what they intended the deposit to be: or are the other criteria set forth above, i.e. the reasonableness of the stipulated sum and relation to probable damages, the difficulty of ascertaining or uncertainty of actual damages, and the variation in likely amounts of damages or in importance of separate branches, also determinants of intent? These other criteria are used for determining the policy of the law with respect to a lease deposit and, therefore, they operate as *limitations* upon intent, but do they also operate directly as determinants of intent? The question is important. The intent of the parties controls the nature of the deposit unless the intent conflicts with a policy of the law. If the parties can decide the issue of intent by the language they use, certainty in lease deposit agreements would seem to be greatly furthered; the other criteria mentioned cannot play such havoc with the intention of the parties if they operate only as limitations upon it and not as determinants as well. The court has used language which suggests that they will look beyond the language of the parties to determine intent.[14] On

Exeter Company v. Holland Corporation, 172 Wash. 323, 20 P.2d 864 (1933); Mosler v. Woodell, 189 Wash. 583, 66 P.2d 353 (1937); The Pacific and Puget Sound Bottling Company v. Clithero, 162 Wash. 156, 298 Pac. 316 (1931); Wai v. Parks, 43 Wn.2d 562, 262 P.2d 198 (1953).

[13] The following facts might be cited in support of the court's statement: (1) the declaration was made in a leading case involving a lease. Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362 (1920); (2) the court has followed the declaration in two cases involving contracts. Erickson v. Green, 47 Wash. 613, 92 Pac. 449 (1907), Stoner v. Shultz, 69 Wash. 687, 125 Pac. 1026 (1912). No distinction is made between lease and contract cases in this area; (3) in deciding the cases, the court often considers other factors in addition to the descriptive words of the parties. In Wilbur v. Taylor, 154 Wash. 282, 295, 282 Pac. 65, 70 (1929), where the expression of intent in the lease agreement was quite complete the court nevertheless considered the "situation of the parties at the time it was entered into"; In Mosler v. Woodell, 189 Wash. 583, 66 P.2d 864 (1937), the lease recited, "provision is so made herein for the reason that it is impracticable or extremely difficult to ascertain the actual amount of damage." In spite of this rather complete expression of intention the court considered the circumstances under which the agreement was made finally concluding that the parties meant what they said.

[14] For example, it is usually said that a sum fixed as liquidated damages must not be so disproportionate to the *probable* damages suffered as to appear unconscionable; thus this criterion is capable of being used to determine what the intent of the parties was before the breach, as well as what the policy of the law is after the breach. Madler v. Silverstone, 55 Wash. 159, 104 Pac. 165 (1909); Benjamin Franklin Thrift Stores v. Jared, 192 Wash. 252, 73 P.2d 525 (1937). See Mosler v. Woodell, 189 Wash. 583, 66 P.2d 353 (1937), where the court considered the circumstances under which the agreement was made in spite of a clear expression of intent in the lease agreement. See also Smith v. Lambert, 109 Wash. 529, 531, 187 Pac. 362, 363 (1920), where the court

the other hand, there is language in the cases which indicates that where the parties express their intent clearly, the other factors will operate only as limitations upon intent.[15] A conclusion from this language might be that other criteria will be considered in determining intent only where there is no clear expression of intent by the parties and that where such an expression is made it will control on the intent issue.[16]

Assuming that a clear expression of intent will be conclusive upon that issue, what type of expression will be successful? The cases indicate that a spelling out of the purpose of the deposit and intended

---

said, "That intention is to be determined by whether in view of the actual breach complained of, the amount provided for in the contract can fairly be regarded as a penalty or as a fair measure of the real damages in the minds of the parties most capable of determining the possible effect of the breach of contract."

[15] In spite of the term "probable damage," when the whole statement of the law (a part of which is noted in footnote 14, first sentence) is examined, it appears that the court considers such factors only limitations on, not determinates of, the intent of the parties. For example, in Madler v. Silverstone, *supra* at note 14, the complete statement is, "Generally speaking, it may be said, that when the damages arising from the breach of contract which the obligation is given to secure, are uncertain in their nature and not readily susceptible of proof by the ordinary rules of evidence, and are not so disproportionate to the probable damages suffered as to appear unconscionable, and *it is reasonably clear from the whole agreement that it is the intention of the parties to provide for liquidated damages and not a penalty*, such a stipulation will be held to be one for liquidated damages." [Italics added.] This is a contract case but it is cited in many lease cases for this statement including Smith v. Lambert, *supra* at note 14, Benjamin Franklin Thrift Stores v. Jared, *supra* at note 14, and Mosler v. Woodell, *supra* at note 14, the latter paraphrasing the Madler case as follows: "Such a stipulation will be held to provide for liquidated damages, if difficult of proof, and the amount agreed upon is not so disproportionate to the probable damages as to be unconscionable . . . *providing, of course, that it is reasonably clear from the contract that the parties intended to stipulate for liquidated damages and not a penalty.*" [Italics added.] See also Meade v. Anton, 33 Wn.2d 741, 758, 207 P.2d 227, 236 (1949), where the court again cites the quoted statement from the Madler case; and Management, Inc. v. Shassberger, 39 Wn.2d 321, 327, 235 P.2d 293, 297 (1951), where the court relies upon 1 RESTATEMENT, CONTRACTS 552 § 339 stating "(1) An agreement, made in advance of breach, fixing the damages therefor, is not enforceable as a contract and does not affect the damages recoverable for the breach unless (a) the amount so fixed is a reasonable forecast of just compensation for the harm that is caused by the breach, and (b) the harm that is caused by the breach is one that is incapable or very difficult of accurate estimation."

[16] In the following cases the court apparently relied entirely upon the language of the agreement for a determination of the intent of the parties; Martin v. Siegley, 123 Wash. 683, 212 Pac. 1057 (1923), where the agreement provided that the deposit was delivered "to secure the performance of this lease by said lessee"; Stern v. Green, 127 Wash. 429, 221 Pac. 201 (1932) where the receipt given by the lessor for the deposit recited that the deposit was received from the lessee "to be held as guaranty of lease."; Exeter Company v. Holland Corporation, 172 Wash. 323, 20 P.2d 864 (1933), where the lease agreement provided that the deposit was paid to the lessor "as security to the lessor for the full performance on the part of the lessee of all the terms, covenants and conditions in this lease on the part of the lessee to be performed."; Wilbur v. Taylor, 154 Wash. 382, 232 Pac. 65 (1929), where the agreement provided "the buyer does hereby agree to secure the faithful performance of this contract and each and every covenant and condition hereunder and to pay to each "owners" the sum of $1000 and execute two promissory notes . . ."; Pacific and Puget Sound Bottling Company v. Clithero, 162 Wash. 156, 298 Pac. 316 (1931), where it was provided that the deposit would "be forfeited as liquidated damages on account of the breach or default of the lessee." This latter less than perfect expression appeared to be what the court relied upon in finding the deposit to be for liquidated damages.

consequences is a wise precaution.[17] For example, if the deposit is intended as one for security a provision that the deposit is made as security for performance and that the lessor is to retain it only to the extent that he is damaged by a breach should be included.[18] Similarly, if liquidated damages is intended, it should be provided that the deposit is made as liquidated damages, the entire deposit to be retained by the lessor in lieu of performance if there is a breach, for the reason that actual damages are likely to be uncertain or difficult to ascertain.[19] Such provisions should be sufficient but as a clincher an explanation of what the deposit is *not* might be added.

Reasonableness of Stipulated Sum and Relation to Probable Damages. If this factor is not a determinant of the intent of the parties it is at least a limitation upon it.[20]. Unless the deposit is reasonable in relation to the probable damages caused by the breach, it cannot be treated as liquidated damages, but rather will be treated as a penalty and only actual damages awarded. Assuming the deposit must be reasonable in relation to the probable damages, what are the "probable damages"? Are they merely the probable damages resulting from a failure to pay rent or does the term also include such damages as may result from breach of the covenant to pay insurance or other lesser covenants? If "probable damages" means those likely to result from breach of every variety of covenant, regardless of importance, how can any deposit be reasonable in relation to all of them? Without expressly saying so, the Washington court appears to solve the problem by looking only to rental.[21] A rationale for this position is that breach of any covenant may result in termination of the lease and the damages resulting will be

[17] See the expressions employed in the cases cited in footnote 16; the court relied upon these expressions to determine the intent of the parties. *But see* Mosler v. Woodell, 189 Wash. 583, 66 P.2d 353 (1937), where the lease recited "provision is so made herein for a liquidated amount, in case of any such breach, for the reason that it is impracticable or extremely difficult to ascertain the actual amount of damages." In spite of this seemingly clear expression the court cautiously goes on to consider the "circumstances under which the agreement was made" finally concluding that the parties meant what they said.

[18] See the expression used in: Martin v. Siegley, 123 Wash. 683, 212 Pac. 1057 (1923); Stern v. Green, 127 Wash. 429, 221 Pac. 201 (1932), Exeter Company v. Holland Corporation, 172 Wash. 323, 20 P.2d 864 (1933); Wilbur v. Taylor, 154 Wash. 282, 282 Pac. 65 (1929); these are set out in note 16.

[19] Mosler v. Woodell, 189 Wash. 583, 66 P.2d 353 (1937) contains perhaps, the best example, set out in note 17.

[20] Madler v. Silverstone, 55 Wash. 159, 104 Pac. 165 (1909); Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362 (1920); Benjamin Franklin Thrift Stores v. Jared, 192 Wash. 252, 73 P.2d 525 (1937); Mosler v. Woodell, 189 Wash. 583, 66 P.2d 353 (1937); Management, Inc. v. Shassberger, 39 Wn.2d 321, 235 P.2d 293 (1951), the court adopting 1 RESTATEMENT, CONTRACTS 552 § 339 as the rule of the case.

[21] See the language in Munson v. Baldwin, 88 Wash. 379, 383, 153 Pac. 338, 340 (1915); Barrett v. Monro, 69 Wash. 229, 232, 124 Pac. 369, 379 (1912); Smith v. Lambert Transfer Co., 109 Wash. 529, 532, 533, 187 Pac. 362, 363 (1920).

loss of rental.[22] As to what is a reasonable sum, each case must in a great measure depend upon its own facts,[23] so authority from cases involving different types of contracts,[24] and even from cases involving the same type of agreement,[25] are of limited value in deciding the issue of reasonableness in a particular case.[26] Washington has not as yet held a *lease* deposit, stipulated by the parties to be liquidated damages, unreasonable and, therefore, a penalty.

Difficulty of Ascertaining or Uncertainty of Actual Damages. This factor is the purpose of providing for liquidated damages. Its presence is probably an indication that the parties intended to provide for liquidated damages.[27] Its absence probably precludes a provision for liquidated damages.[28]

Variation in Likely Amount of Damages or in Importance of Separate Breaches. The importance of this factor is not, as yet, well defined in Washington. It has been referred to in lease cases[29] and was apparently relied upon in a contract case,[30] and yet it would seem to be in

---

[22] Burns Trading Co. v. Welborn, 81 F.2d 691, 695 (10th Cir. 1936), 106 A.L.R. 285. The court explained, "We are of the opinion that the parties had in mind, and intended to provide, not for the damages that the Burns Company would suffer from the breach of a covenant, for which the contract gave it the optional remedy of termination of the lease, but for the loss it would incur on such a termination before the expiration of the term, because of possible delay in securing a new tenant, possible expense of alterations to suit the new tenant, possible decreased rental, and the expenses of securing a new tenant. Such damages would be the same regardless of the character of the breach invoked as a ground for terminating the lease and they would be damages of such uncertain character that it would be difficult to ascertain and measure them accurately in money."

[23] Management v. Shassberger, *supra* at note 20.

[24] Madler v. Silverstone, 55 Wash. 159, 104 Pac. 165 (1909), involving a sale of realty; Foster v. Montgomery Ward and Co., 24 Wn.2d 248, 163 P.2d 838, involving a sale of personalty; Mead v. Anton, 33 Wn.2d 741, 207 P.2d 227, and Management v. Shassberger, 39 Wn.2d 321, 235 P.2d 293, involving a sale of a business with a covenant not to compete.

[25] Management v. Shassberger, *supra* note 24 at page 329.

[26] The Washington court held reasonable a deposit of $1,500 where the lease was for four years at a monthly rental of $370, Munson v. Baldwin, 88 Wash. 379, 153 Pac. 338 (1915); a deposit of $1,200 for a five-year lease at a monthly rental of $600, Barrett v. Monro, 69 Wash. 229, 124 Pac. 369 (1912); a deposit of $5,000 where the total amount of the rent provided for in the lease amounted to $76,500; Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362 (1920).

[27] Mosler v. Woodell, 189 Wash. 583, 66 P.2d 864 (1933).

[28] Madler v. Silverstone, 55 Wash. 159, 104 Pac. 165 (1909); Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362; Benjamin Franklin Thrift Stores v. Jared, 192 Wash. 252, 73 P.2d 525 (1937); Management, Inc., v. Shassberger, 39 Wn.2d 321, 235 P.2d 392 (1915); Stoner v. Shultz, 69 Wash. 687, 125 Pac. 1026 (1912).

[29] Everett Land Co. v. Maney, 16 Wash. 552, 557, 48 Pac. 243, 244 (1897); Madler v. Silverstone, *supra* note 28, Smith v. Lambert Transfer Co., *supra* note 28; Wilbur v. Taylor, 154 Wash. 282, 293, 282 Pac. 65, 69 (1920); Sledge v. Arcadia Orchards Co., 77 Wash. 477, 137 Pac. 1051 (1914).

[30] In Sledge v. Arcadia Co., *supra* note 29, where $60 an acre was to be paid for failure to (1) plant apple trees in the spring as early as the weather would permit, (2) to plant a cover crop between the rows, and (3) to care for the trees after planting, the court found the performances to be of different degrees of importance and held that

conflict with the test of reasonableness; if, as suggested previously,[31] the Washington court looks only to the rental in determining the reasonableness of the deposit, then a wide variation in probable damages from breaches of other covenants would seem immaterial; if, on the other hand, the court looks to all the covenants when determining the reasonableness of the deposit, then this factor would seem to be nothing more than the test of reasonableness applied to every covenant in the lease. The test would seem of doubtful importance or utility in Washington.

The Doctrine of Dutton v. Christie—Ownership of Deposit. Under the Washington cases there is one method by which the parties can achieve a relatively great degree of certainty as to the ultimate ownership of the deposit or stipulated sum: they can provide that it shall be vested in the lessor as consideration rather than as damages.[32] In the lease in the leading case, *Dutton v. Christie*, it was first recited that the deposit was consideration; in a subsequent paragraph the parties provided that in the event of full performance of the contract by the lessee the deposit would be credited in payment of rent for the last two months of the term, but otherwise would belong to the lessor as a part of the consideration to them for the execution of the lease.[33] The lessee breached and the court held that when he paid the deposit it was consideration for the lease and title to it passed to the lessor. Therefore, the deposit was neither liquidated damages nor security for performance, so that breach by the lessee made him liable to the lessor for damages caused by the breach in addition to his loss of the deposit. The result was the same where a note was given as "further consideration" for the execution of the lease with a provision that if the lessee should fully perform his obligations the deposit would be applied upon the last six months rental but otherwise would belong to the lessor as part of the consideration of the lease.[34] Where there was no initial provision that the deposit was consideration but only a provision that, if the lessee should fully perform his obligations, the deposit would be applied upon the last six months rental but otherwise would belong to

---

the stipulated sum could not be sustained except as a penalty, authorizing recovery only of damages actually sustained.

[31] *Supra* at note 21.

[32] Dutton v. Christie, 63 Wash. 372, 115 Pac. 856 (1911); General Petroleum Corporation of California v. Harry Wright's Inc., 166 Wash. 636, 8 P.2d 291 (1932); Rice v. Weisberger, 170 Wash. 35, 15 P.2d 259 (1932); Sanders v. General Petroleum Corporation of California, 171 Wash. 250, 17 P.2d 890 (1933).

[33] Dutton v. Christie, *supra* note 32.

[34] General Petroleum Corp. of California v. Harry Wright's Inc., 166 Wash. 636, 8 P.2d 291 (1932).

the lessor, title to the deposit was again held to be in the lessor although here it would not seem as clear that title had been vested in him from the beginning of the term.[35]

The essential requisite of this rule appears to be that title to the deposit be vested absolutely in the lessor, *as consideration* under *both* alternatives, i.e. whether the lessee performs or fails to perform. The performance of the lessee is a condition which determines only the application of the deposit by the lessor; if the lessee performs he applies it to the rent; if the lessee fails to perform he does not apply it to the rent but *either way* the lessor takes title to the deposit *as consideration rather than as damages.* The lessee by full performance, may earn the right to a reduction of rent, but in any event, title to the deposit itself is vested immediately in the lessor and is not affected by the contingency.[36] The obvious advantage to the lessor is that he can *recover full damage for the breach and still retain the entire deposit.*[37]

---

[35] Sanders v. General Petroleum Corporation of California, 171 Wash. 250, 17 P.2d 890 (1933). The lessor in this case is the lessor in General Petroleum Corporation of California v. Harry Wright's Inc., *supra* note 34, and the language of the lease provisions, so far as set out by the court, is nearly identical. From this we might surmise that the Sanders case too contained an initial provision making the deposit consideration at the outset. Nevertheless the court did not set it out nor appear to rely upon it so that it would seem that the following provision in the Sanders case is sufficient to vest title to the deposit absolutely in the lessor: "If the lessee shall have fully performed each and every obligation on his part to be performed hereunder, and if said note is paid on demand, the sum of $1050 so paid shall be applied upon the last 6 months rental of this lease but otherwise said note and/or said sum of $1050 or any unapplied portion thereof shall belong to the lessor as part of the consideration for this lease." Despite the apparent sufficiency of this clause, a suggested precaution is to preface such a provision with an acknowledgement of the receipt of the deposit as consideration for the execution of the lease.

[36] Dutton v. Christie, 63 Wash. 372, 115 Pac. 856 (1911). The court states that, "In the beginning of the lease the parties have declared that the lease is given in consideration of the covenants of the second parties and of the payment of $1,500." The court then asks whether the added provision, that the deposit would be applied to the rental if the lessee fully performed but otherwise would belong to the lessor as part of the consideration for the execution of the lease, changed the nature of the deposit from consideration to a penalty. In answer to its own question the court said, "We think not. It is declared to be a part of the consideration in the beginning, and this clause reiterates the same thing. In both instances the ownership of the respondent therein is affirmed. This is not changed by his agreement to apply this sum in payment of the rent for the last two months of the term in the event of the appellants fully performing their contract."

[37] Dutton v. Christie, *supra,* note 36. The lessor was allowed to retain the deposit *and* recover in full for damages caused by the lessee's breach. The discerning reader might ask whether or not this result actually amounts to a penalty? The answer would seem to be that a penalty is certainly possible and perhaps even probable. If the parties are careful to stay within the forms approved by the court under the Dutton rule the court will apparently give no consideration at all to the equities; the court's constant vigilance against penalties in the liquidated damages cases is forgotten when the parties talk only in terms of consideration. But how persuasive is the fact that the deposit is expressly made, received, and retained as consideration when it is remembered that every lease deposit is part of the bargained for consideration? In Barrett v. Monro, 69 Wash. 229, 124 Pac. 369 (1912), Judge Crow expressly recognized that a deposit made as liquidated damages was as much consideration for the execution of the lease

The cases must be distinguished in which the lessor, under one of the alternatives, takes title to the deposit *as damages* or does not take title at all. For example, where the lease recited that the deposit was paid to the lessors as consideration but subsequently provided that if there was any default by the lessee the deposit should be forfeited to the lessor as liquidated damages, it was held that the deposit provision fixed the measure of damages; the lessor was not permitted to recover damages in excess of that amount.[38] And where the lease provided that the deposit was made in payment of the last several monthly installments, and as security for the faithful performance of the lessee's covenants, and subsequently provided that the deposit should be forfeited as liquidated damages in the event of default, the lessor was held entitled to the deposit, but only as liquidated damages.[39] In another case, the court distinguished *Dutton v. Christie* in construing a lease which provided that the deposit should be returned to the lessee in the event of full performance by him, but otherwise should belong to the lessor as a part of the consideration to him for the execution of the lease.[40]

Is the obligation of the landlord to return or otherwise apply the deposit a covenant running with the land?

as the deposit in the Dutton case, but instead of cutting down the rule of the Dutton case so that a penalty might be found by a consideration of the equities, he expressly relied upon the Dutton case for a holding that the landlord could keep the entire lease deposit. It is interesting to note that the reliance was in error as the doctrine of the Dutton case has subsequently developed; the language of the lease put it clearly outside the rule; further, the reliance was not necessary to the holding since the landlord sued only for the deposit and did not ask for actual damages in addition. The Barrett case was actually a liquidated damages holding and has been subsequently relied upon as such. Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362 (1920).

[38] The Pacific & Puget Sound Bottling Company v. Clithero, 162 Wash. 156, 298 Pac. 316 (1931). The lessor argued that the Dutton case was controlling but the court distinguished it because, "In that case, fifteen hundred dollars was paid in consideration of the execution of the lease, but there is no subsequent provision therein, as here, making the sum named liquidated damages. In that case, it was expressly recognized that "the money was not deposited as security." Here, the two thousand dollars paid at the time the lease was executed being made liquidated damages it thereby became security for any covenants in the lease which it covered. Since damages for the breach of the covenant to pay rent were provided for in the two thousand dollars specified as liquidated damages, this sum having been previously paid, no money judgment can now be rendered against the appellants."

[39] Smith v. Lambert Transfer Co., 109 Wash. 529, 187 Pac. 362 (1920).

[40] Stern v. Green, 127 Wash. 429, 433, 221 Pac. 601, 602 (1932). Here too the lessor relied upon Dutton v. Christie, but the court distinguished that case because "In this case, there was no recital in the stated consideration for the lease that the $1,000 should be a part of the lease. There was a recital in the paragraph in the lease, after the provision that, in the event of the full and faithful performance of all the covenants and agreements of the lease to be performed by the lessee, the bond should be returned to the lessee at the termination of the lease, otherwise to belong to the lessors as part of the consideration for the execution of the lease. . . . There was no provision that it should be applied to the last two months of the lease, and there was no provision that it should belong absolutely to the lessor from the beginning of the term."

The problem discussed thus far arises only when the tenant has breached his covenants. If the lessor sells his interest in the reversion, whether the tenant performs or not, the question may arise as to whether the lessor's obligation to return the deposit, or to apply it as may be provided in the lease, is a covenant running with the land? Research has not revealed a Washington decision on the question.[41] There are three views the court might adopt. It has been held that the lessor's obligation to return or otherwise apply the deposit is (1) a covenant which does not run with the land, (2) a covenant which does run with land, and (3) not a covenant at all, but merely the duty of a pledgee which passes with the pledged deposit.

It has been held in New York that the obligation to return the deposit does not run with the land so that the lessor's grantee, though he take subject to the lease, cannot be held liable for the return of the deposit.[42] But care should be exercised in relying upon New York law in this area because it has been somewhat complex and conflicting. Probably, the lessor has no duty to return the deposit until the lease has expired even though he has no further interest in the leased premises.[43] However, when the lease does expire, the lessor must return

---

[41] In Barrett v. Monro, 69 Wash. 229, 230, 124 Pac. 369 (1912), the question was not raised and the court simply assumed that the landlord's grantee succeeded to the lessor's rights and liabilities with respect to the deposit; it is, therefore, doubtful that the court's statement that "Defendants have succeeded to all rights and liabilities of the original lessors . . ." can be regarded as even dicta on the point.

[42] Fallert Brewing Co. v. Blass, 119 App. Div. 53, 103 N.Y. Supp. 865 (1907); Cohen v. Birns, 170 N.Y. Supp. 560 (1918).

[43] Mauro v. Alvino, 90 Misc. 328, 152 N.Y. Supp. 963, 964 (1915). Two reasons are advanced by the court: (1) "The term of the lease has not yet expired, and the lease is in full existence, yet by the terms of the lease he has agreed to return the deposit only at the expiration of the lease, and that time has not yet arrived." (2) "The grantee who takes subject to a lease should also on principle obtain the benefit of security deposited for the due performance of the lease. While he cannot compel his grantor to transfer the deposit to him, because the grantor is bound by his covenant with the lessee personally to return it to him at the expiration of the lease, yet so far as the circumstances permit he should receive the benefit of this security. If his grantor is permitted to hold the security exactly as the parties have themselves provided, then upon the expiration of the lease, while the grantor could not counterclaim in his own right for any damages which may have accrued by reason of any breach on the part of the tenants, yet the grantee in whom such right of action rests could assign his chose in action to his grantor, and the grantor could by virtue of such assignment set up the counterclaim. In other words, not only has the time not yet arrived at which the landlord agreed to return the deposit, but the landlord and his grantee, acting together, are still in a position to obtain a benefit from holding the deposit in accordance with the terms upon which it was made." *Accord,* Halsted v. Globe Indemnity Co., 258 N.Y. 176, 179 N.E. 376 (1932), and Rosenfeld v. Aaron, 248 N.Y. 437, 162 N.E. 478 (1928), where the landlord's guarantee assumed the obligation to return the deposit upon full performance by the tenant. The tenant sued both the landlord and his grantee to recover the deposit. *Held,* that the action was prematurely brought; that the deposit may be retained until the right to hold it as security has terminated. Both cases relied upon the Mauro case. However, a case decided before the Halsted and Rosenfeld cases, but after the Mauro case seems to be in conflict with these decisions. In Kottler v. New York Bargain House, 242 N.Y. 28, 150 N.E. 591 (1926), a lessee subleased the

the entire deposit without counterclaim for any breach of covenant by the tenant arising after conveyance of the premises, for the right of action for such breach is no longer in him.[44] Under the same reasoning, the lessor's grantee might be permitted to sue the lessor for the deposit as soon as the grantee is injured by breach of the tenant, whether the lease has expired or not.[45]. The principal difficulty in the New York decisions is the holding that the obligation of the lessor with respect to the deposit *does run* with the land when the landlord has covenanted upon full performance by the tenant, to *apply the deposit to the rent,* rather than merely *returning* it.[46] The distinction does not seem sound,

premises. The sublessee breached the covenant to pay rent. Subsequently, the main lessee surrendered his own lease which the court expressly considered as equivalent to a transfer of the reversion. Following this transfer or surrender the main lessee sued his lesse for the breach. The sublessee was permitted to credit the security deposit against the debt, which, of course, was tantamount to receiving back the deposit before the expiration of the lease contrary to the rule of the Mauro case. The court distinguished the Mauro case. The court agreed that under the Mauro case, *by apt words,* the parties might have agreed that the deposit should be retained until the expiration of the term, though the landlord by assignment or otherwise had no longer an interest in the enforcement of the covenants. But, the court insisted, such an agreement will not readily be gathered from words of doubtful meaning. Yet the only apparent difference between the two cases, so far as language is concerned, is that in the Mauro case the deposit was to be "returned at the expiration of the term of this lease" and in the present case was to be applied to the payment of rent for the last two months of the lease if the covenants of the lease had been fully performed. The language of both cases would seem to manifest an intent that the landlord keep the deposit until the end of the term. And even if the distinction between the cases as to language constitutes a difference, the holding in the Kottler case still ignores the second reason given by the court for the Mauro decision, i.e. that the landlord and his grantee, acting together, are still in a position to obtain a benefit from holding the deposit after the transfer.

[44] Knutsen v. Cinqui 113 App. Div. 677, 99 N.Y. Supp. 911, 912 (1906); the court reasoned, "The action did not accrue until the expiration of the lease, for the plaintiff could have restored the stalls up to that time. It follows that the right of action set up in the counterclaim is in the defendant's grantee. He purchased the land subject to the lease, and succeeded to his grantor's rights under the covenants of the lease." Seidlitz v. Auerbach, 230 N.Y. 167, 129 N.E. 461, 464 (1920); the court explained, without relying on the Knutsen case, "But when the landlords transferred their reversion to Stern, all privity of estate between them and the lessee was ended, and their rights to enforce agreements on the part of the lessee not broken at the time ceased."

[45] Such was the holding in Donnelly v. Resoff, 164 Misc. 384, 298 N.Y. Supp. 946 (1937), a decision by the Municipal Court of New York, Borough of Manhattan Ninth District. The court relied directly upon Seidlitz v. Auerbach, *supra,* note 44. The court also relied indirectly upon Knutsen v. Cinqui, *supra* note 44; a statement from Halsted v. Globe Indemnity Co., 258 N.Y. 176, 180, 179 N.E. 376, 378, that " 'The benefit of a covenant of a surety for the rent runs with the land and, in absence of a stipulation to the contrary, the grantee who takes subject to a lease obtains the benefit of securities deposited for the due performance of the lease'." was quoted and relied upon by the court; the court in the Halsted case relied upon the reasoning in Mauro v. Alvino, 90 Misc. 328, 152 N.Y. Supp. (1915), set out in note 43, for the statement; the reasoning of the Mauro case which was the basis for the quoted statement was expressly based upon the holding in Knutsen v. Cinqui. Although the Donnelly case is not, in itself, strong authority for its holding, the result would seem logical; if the landlord can make no claim against the deposit under the Seidlitz and Knutsen decisions, and yet is entitled to keep it until the expiration of the lease because his grantee, under the Mauro and Halsted case, has a beneficial interest in it, why shouldn't the grantee be allowed to sue him for it when he is injured by a breach that the deposit was given to protect against? Yet, there a flatly contrary statement in the Mauro case, *supra,* note 43.

[46] Shenk v. Brewster, 189 App. Div. 608, 179 N.Y. Supp. 147 (1919); Walker v. 18th

as the dissent in the first such case pointed out;[47] nevertheless it appears to have been adopted.[48] Of course, where the covenant is merely to return the deposit, the lessor's grantee can expressly assume it and be liable as though it had run with the reversion.[49]

In Michigan, it has been held that the covenant to return the deposit on full performance by the tenant runs with the land.[50]

In New Jersey, the deposit is treated as a pledge and the lessor's grantee cannot be held liable for return of the deposit unless he assumes the lessor's obligation as pledgee.[51] The lessor, under the terms of the pledge, may be allowed to keep the deposit until the expiration of the lease though he has no further interest in the reversion.[52]

Since there is, perhaps, no superiority of one view over the others, the need for adequate drafting in this area should be clear.

When does the lessor pay taxes on the deposit?

Just a caution to the draftsman here; a lease deposit clause which nets the landlord a greater advantage in the event of breach may result

---

Street Holding Corporation, 267 App. Div. 141, 44 N.Y. Supp. 2d 866 (1943). Note that these are both decisions by the First Department of the Supreme Court, Appellate Division. Some doubt might be raised as to the weight of the cases as authority because of an earlier case decided by the Court of Appeals, Kottler v. New York Bargain House, 242 N.Y. 28, 150 N.E. 591 (1926), in which the court assumed without discussion that the covenant to apply the deposit upon the last two months rent did not run with the land so that the landlord was liable thereon after transfer of the reversion.

[47] The dissent in the Shenk case, *supra*, note 46, a First Department decision, pointed out the prior inconsistent holding in Fallert Brewing Co. v. Blass, 119 App. Div. 53, 103 N.Y. Supp. 865 (1907), a case decided by the Second Department of the Supreme Court, Appellate Division, and also inconsistent dicta in Mauro v. Alvino, 90 Misc. Rep. 328, 152 N.Y. Supp. 963 (1915), a First Department case; but the dissent failed to call the attention of the majority to a holding by the First Department in Cohen v. Birns, 170 N.Y. Supp. 560 (1918) in which the landlord's grantee was held not liable on a covenant of the landlord to return the deposit on full performance by the tenant.

[48] Although the majority in the Shenk case, *supra* note 46, simply assumed without discussion that the covenant to apply the deposit runs with the land, the court in the Walker case relied upon the Shenk case for a holding that the covenant to *apply* the deposit runs and appeared to recognize a distinction between the earlier cases concerning covenants to *return* the deposit by the statement, "A clause of the present nature is not controlled by the rule that a covenant to return a deposit does not run with the land."

[49] Rosenfeld v. Aaron, 248 N.Y. 437, 162 N.E. 478, 479 (1928), where the court stated, "Here the grantee received the deposit and agreed to indemnify the original landlord. The covenant to return passed to the grantee, subject to the terms of the lease." *But see* Cohen v. Birns, 170 N.Y. Supp. 560 (1918), where the grantee was held not to have assumed the covenant, though there was evidence that she had received a sum equivalent to the amount of the deposit, the court could find no evidence that she had undertaken to return the deposit.

[50] Moskin v. Goldstein, 225 Mich. 389, 196 N.W 415 (1923).

[51] Kaufman v. Williams, 92 N.J. L. 182, 104, Atl. 202 (1918), Central Home and Trust Co. v. Walsh Bakeries and Restaurants, Inc., 165 Atl. 107 (1933), Cummings v. Freehold Trust Co., 191 Atl. 782 (1937), dicta in all three cases indicated that a mere receipt of the deposit by the grantee or a crediting of the deposit on the purchase price of the reversion might constitute an assumption of the landlord's obligation as pledgee to return the deposit. *Cf.* to the New York cases, *supra*, note 49.

[52] Partington v. Miller, 122 N.J.L. 388, 5 A.2d 469 (1939).

in a disadvantage taxwise. Although each case depends upon the provisions of the particular lease,[53] a deposit received by a landlord from his tenant to be held merely as security for performance, with no present right or claim of full ownership by the landlord, unless and until a breach by the tenant puts title in the landlord, is probably not taxable to the landlord until the breach occurs;[54] this may be true even though upon full performance by the tenant the deposit is to be applied to the rent, if the primary purpose of the deposit is to secure performance.[55] The same principles would appear to be applicable to deposits made as liquidated damages. On the other hand, a deposit of advance rental[56] or of consideration for the execution of the lease[57] will be taxable in the year received. It would seem, therefore, that the landlord who is content with a security or liquidated damage provision can, by careful drafting, avoid immediate tax liability, whereas the landlord, who insists that the deposit be in consideration of the execution of the lease so that he can, in the event of breach, retain the deposit and recover damages too, will pay for this contingent advantage with immediate tax liability.[58]

[53] Hirsch Improvement Co. v. Commissioner of Internal Revenue, 143 F.2d 912, 915 (1944).

[54] Warren Service Corporation v. Commissioner of Internal Revenue, 110 F.2d 723 (1940).

[55] Clinton Hotel Realty Corporation v. Commissioner of Internal Revenue, 128 F.2d 968 (1942). *But cf.* Gilken Corporation v. Commissioner of Internal Revenue, 176 F.2d 141 (1949), where the landlord was held immediately liable because of his unrestricted use of the deposit.

[56] Renwick v. United States, 87 F.2d 123 (1936); Commissioner v. Lyon, 97 F.2d 70 (1938); Astor Holding Co. v. Commissioner of Internal Revenue, 135 F.2d 47 (1943).

[57] Crile v. Commissioner of Internal Revenue, 55 F.2d 804 (1932); Gates v. Helvering, 69 F.2d 277 (1934).

[58] However, under Section 452 of the 1954 Code, an accrual-basis taxpayer is given the right to elect to defer, for a period not exceeding six years including the taxable year of receipt, the reporting of advance payments as income until the year or year in which such income is earned.