Updates

Unlike residential leases, there are relatively few statutory requirements for commercial leases.

A new California Senate bill (SB 1103 or the Bill) provides commercial tenant protections by amending several sections of the California Civil Code relating to commercial tenancy. These statutory protections will apply regardless of the negotiated terms of the lease amendment. The Bill, which goes into effect on January 1, 2025, now requires (1) certain specified conditions to be met for building operating expenses charged to qualified commercial tenants; (2) longer written notice periods for rent increases and lease terminations; and (3) commercial leases negotiated in Spanish, Chinese, Tagalog, Vietnamese, or Korean to be also provided in writing in those languages.

SB 1103 only applies to "qualified commercial tenants," which is a newly defined class of tenants of commercial properties. A qualified commercial tenant is a "microenterprise," a restaurant with fewer than 10 employees, or a nonprofit with fewer than 20 employees. The California Business and Professions Code defines a "microenterprise" as a sole proprietorship, partnership, limited liability company, or corporation that (1) has five or fewer employees, including the owner, who may be part-time or full-time and (2) generally lacks sufficient access to loans, equity, or other financial capital. A "nonprofit organization" refers to any private, nonprofit organization that qualifies under Section 501(c)(3) of the U.S. Internal Revenue Code of 1986.

While this summary focuses on the impact on commercial leases, the provisions of SB 1103, including the new language requirement, also extend to other real estate-related contracts, including, but not limited to, loan agreements, reverse mortgages, fee statements, and foreclosure agreements.

Conditions for Charging Tenants Building Operating Cost Recovery Fees

SB 1103 imposes strict rules for landlords charging "building operating costs," which are defined by the Bill as costs that are incurred on behalf of a tenant for the operation, maintenance, or repair of the commercial real estate property, including, but not limited to, maintenance of common areas, utilities that are not separately metered, and taxes or assessments charged to the landlord pursuant to property ownership. While most triple net leases already contemplate some proportionate distribution of building operating costs, SB 1103 goes a step further in requiring "supporting documentation" provided by the landlord to the qualified commercial tenant. Supporting documentation is defined as a dated and itemized quote, contract, receipt, or invoice from a licensed contractor or a provider of services that includes, but is not limited to, (1) a tabulation showing how the costs are allocated among tenants and (2) a signed and dated attestation by the landlord that the documentation and costs are true and correct.

There is a time-period restriction such that the building operating costs must have been incurred within the previous 18 months or are reasonably expected to be incurred within the next 12 months. While some existing leases are negotiated to include a base year, such language does not necessarily restrict landlords to a particular time period for recovering *all* building operating costs.

Prior to the execution of the lease, the landlord must provide tenants with a paper or electronic notice stating that the qualified commercial tenant may inspect any supporting documentation upon written request. Whenever tenants exercise this right, landlords will have 30 days following the written request to provide the qualified commercial tenant supporting documentation of the previously incurred or reasonably expected building operating costs. Further, landlords cannot charge any fees to recover operating expenses until the landlord provides the qualified commercial tenant with supporting documentation regarding such fees. This section of the Bill ultimately provides qualified commercial tenants with a built-in audit right, even when one was not negotiated or contemplated by the parties.

This section specifically applies to (1) leases executed or tenancies commenced or renewed on or after January 1, 2025; (2) a tenant that leases from week to week, month to month, or other period less than a month; and (3) leases executed or tenancies commenced before January 1, 2025, that *do not* contain a provision regarding building operating costs. While it is rare to see leases without building operating cost provisions, what is not clear is the type of retroactive measures that are required to make sure that such provisions comply with the new Bill. SB 1103 also does not provide much guidance on the third requirement mentioned above. For example, must the "provision" include a numerated list of all costs to be charged? Must it include exclusions? What about audit rights? There is not enough detail in the Bill to determine if existing provisions will suffice. Moreover, where there is no such provision (except, of course, in full gross leases where no such provision is required) to recover building operating expenses, the Bill requires that the landlord provide notice regarding the qualified

commercial tenant's right to inspect supporting documentation *before* signing the lease. Presumably, a lease amendment would be sufficient to cure this ill, but the statute does not provide any guidance to landlords for leases executed or tenancies that commenced prior to January 1, 2025.

Also of note is that SB 1103 prohibits landlords from altering the method or formula used to allocate building operating costs to the qualified commercial tenant in a way that increases the tenant's share of these costs unless the qualified commercial tenant is provided written notice of the change with supporting documentation for the basis of the alteration.

The penalties for landlords are not light. A violating landlord will be liable for actual damages and reasonable attorneys' fees and costs. If the qualified commercial tenant can show that the landlord acted willfully or with oppression, fraud, or malice, the landlord will be liable for *three times* the amount of actual damages and punitive damages.

Longer Notice Periods for Rent Increases and Lease Terminations

Rent Increases

SB 1103 imposes new notice requirements to increase rent when the term of the lease is week-to-week, month-to-month, or any period less than a month. First, landlords can only increase the rent provided in the lease upon giving written notice to the qualified commercial tenant either personally or by mail. For proposed rent greater than a 10% increase of the rental amount charged during the 12 months before the effective date of the increase, the notice must be delivered at least 90 days before the effective date of the increase. For proposed rent less than a 10% increase, notice shall be delivered at least 30 days before the effective date of the increase. A 30-day notice period is also required if the proposed rent increase is due to a change in the tenant's income as determined by the recertification.

Lease Terminations

Despite the negotiated terms of the commercial lease, landlords must now give qualified commercial tenants at least 60 days' notice prior to the proposed date of termination unless the tenant has occupied the property for less than one year. As is the case with existing law, landlords can still give 30 days' notice if the qualified commercial tenant occupied the property for more than one year. Qualified commercial tenants also must give notice to terminate for a period which is at least as long as the term of the tenancy prior to the proposed date of termination.

Leases Must Use the Same Language as Negotiations

A landlord and tenant who negotiate primarily in Spanish, Chinese, Tagalog, Vietnamese, or Korean shall deliver a translation of every term or condition in the lease to the other party. At the time the lease is executed, notice in any of the languages mentioned above in which the lease was negotiated shall be provided to the tenant. However, documents incorporated by reference, such as rules and regulations or inventory lists, do not need to be translated.

Upon a failure to comply with the provisions of this section, the person aggrieved (either the landlord or the qualified commercial tenant) may rescind the lease. This provision of SB 1103 lacks a time limit for such recission, which may create uncertainty for either party.

Other Considerations

1. The protections are not automatic; to benefit, qualified commercial tenants will have to provide landlords (within the previous 12 months) with a written notice that the tenant is a qualified commercial tenant, along with a self-attestation regarding the number of employees. Further, unless the tenancy is for a period of less than a month, the tenant must provide the notice and self-attestation before or upon execution of the lease **and** annually thereafter.
2. SB 1103 applies to leases executed or tenancies commencing or renewing *on or after* January 1, 2025. Landlords should consider executing lease amendments to all leases executed prior to January 2025 to ensure compliance.
3. SB 1103 largely looks at the size of the company measured by the *number of employees* and *not* the company's earnings or the size of a leased premises. While the general tone of the Bill is to protect smaller businesses, a larger entity, such as a restaurant that occupies a sizeable space but employs fewer than 10 people, would still be considered a qualified commercial tenant under a strict reading of the Bill.
4. SB 1103 applies solely to qualified commercial tenants. Therefore, companies that do not fall within the definition of a qualified commercial tenant remain largely unaffected; although, the Bill gives rise to questions on how SB 1103 would affect the market generally.

For more information on SB 1103 and how it may affect your company's current or future real estate contracts or to ensure compliance of existing leases with SB 1103, please contact a lawyer from Perkins Coie's Real Estate and Land Use team.

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