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## Security Deposits: Application of Security Deposits

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In light of the financial difficulties attributable to the COVID-19 pandemic, commercial tenants are increasingly defaulting on their rent payments. Landlords are limited in their options for recovering these payments due to the executive order prohibiting non-essential services, which has prevented service of rent demand notices and prevented courts from accepting new filings of nonpayment petitions. Given the unknown duration of the pandemic, commercial landlords are left in limbo on how to collect these arrears.

As such, many of our commercial clients have reached out requesting more information about tenant defaults, bankruptcies, and the application of security deposits to offset rent arrears. In his daily briefing on May 7, 2020, Governor Cuomo announced that landlords may apply security deposits as payment in lieu of their normal monthly rent. But, this is nothing new. Many commercial leases already allow landlords to apply security deposits towards rent defaults and expenses associated with the collection of rent defaults. If a tenant fails to make a rent payment on its due date, or within any applicable grace period permitted by the lease, the tenant is considered to have monetarily defaulted on its lease. If the lease provides that the security deposit can be applied towards a rent default, and does not contain a notice provision, the landlord has the right to apply the security deposit immediately.

Typical lease provisions that allow landlords to apply security deposits to cure a rent default also require the tenant to replenish the security deposit. We believe that Governor Cuomo's forthcoming executive order should address whether these provisions will be modified in any way. Subject to further clarification via executive order, landlords who apply security deposits should send notice to the tenant within the time frame set forth in the lease indicating that the security deposit was applied and provide the exact amount the tenant must pay in order to replenish the security deposit. Failure by the tenant to replenish its security deposit in the specified time frame could result in a lease default and another basis for termination of its lease. However, in the current time period, replenishment may not be feasible.

Further, landlords are concerned about tenants declaring bankruptcy and whether a bankruptcy will have any negative implications regarding security deposits used as offsets against rent. When a tenant declares bankruptcy, an automatic stay goes into effect, meaning the landlord will not be able to pursue any collection remedies, including the application of the security deposit. Instead, the security deposit will technically become part of the bankruptcy estate to be distributed to creditors at a later date. However, there is also a bankruptcy provision which, in this context, allows landlords to use security deposits as an offset against rent. To complicate matters further,

there is an additional bankruptcy provision which indicates that a payment not made in the regular course of business ninety (90) days before a tenant declares bankruptcy can be deemed a “preferential transfer” that the landlord may have to surrender back to the bankruptcy trustee. Our net take on the interplay of these statutes is that landlords should take prompt action to apply the security deposits of any tenants they suspect may declare bankruptcy because a landlord’s claim for a security deposit offset would likely be a successful defense to a “preferential transfer” claim.

Of course, each situation should be evaluated individually, preferably with legal counsel, by reviewing the applicable lease security deposit provisions before taking such actions.

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