

Insights

U.S. COVID-19: APPLYING SECURITY DEPOSITS UNDER LEASES AS TENANT DEFAULTS MOUNT

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Many commercial tenants failed to pay April rent. Landlords may be thinking about applying security deposits or drawing down on letters of credit to cover tenants' defaults. At this point, some tenants may be asking their landlords to apply their security deposits to missing rent payments.

Generally, landlords should follow the lease terms concerning how to apply a cash security deposit or draw down a letter of credit. Most leases allow landlords to use the security deposit to pay the tenant's rent immediately or after a short grace period. A negotiated commercial lease may require that before a landlord can use a security deposit, the landlord must give the tenant a written default notice and an opportunity to cure (within a specified time frame). That said, using a tenant's security deposit may not be so easy. We have flagged some considerations to keep in mind concerning preparing to use a tenant's security deposit.

- **CONFLICTS BETWEEN THE LAW AND THE LEASE.** Landlords should confirm that cash security deposits are held in a lawful manner and that the lease's process for applying the security deposit does not conflict with applicable legal requirements. Particularly with residential leases, state and local laws can: (1) cap the size of the security deposit (and whether other deposits, like a pet deposit, could count towards the size limitation), (2) limit the use of the security deposit, and (3) specify the manner and timing of its application. The law may prohibit any use of the security deposit until the lease terminates or expires. Moreover, as politicians and officials react to the financial distress caused by COVID-19, new governmental directives may impact the handling of security deposits.
- **NO TENANT DUTY TO REPLENISH.** Under most leases, security deposits are "evergreen" which means that once the landlord applies the security deposit, the tenant is required to replenish it on demand. Not all security deposits are evergreen – some leases do not require replenishment, and landlords should not assume that they will be entitled under the law to demand replenishment in the absence of a lease provision giving them that right. Modifying a lease to make the security deposit evergreen may become part of rent relief negotiations.

- **THE SECURITY DEPOSIT IS BURNING DOWN.** Some negotiated commercial leases provide that the amount of the security deposit will “burn down” at specified times during the lease term. Some leases have conditions on those reductions. For example, a typical condition requires that no tenant default (beyond applicable notice and cure periods) exists when the particular reduction is scheduled to occur. In other leases, the reductions are automatic. Landlords should review all reduction conditions and give default notice where needed to stave off burn downs. Where no such conditions exist and a reduction is imminent, then a landlord may be incentivized to draw on that security deposit quickly. Bolstering “burn down” conditions and changes in a reduction schedule may become part of rent relief negotiations.
- **THE GOLDEN RULE.** Often the landlord agrees to limitations on its right to apply security deposits in loan documents. Those requirements need to be reviewed and followed before a landlord can use a tenant’s security deposit.
- **LETTERS OF CREDIT - PREDICAMENTS OF PRESENTMENT.** Not all letters of credit are created equal. Letters of credit should be carefully reviewed and followed. The letter of credit should specify the draw process; however, the details of that process are not always complete. Procedural and practical barriers to presentment may exist. The following are examples of what landlords may be asking themselves to identify those issues.
 - Many letters of credit require the landlord to provide the original letter of credit (and any amendments) to the issuer for payment. What if the landlord gave the original letter of credit to its mortgage lender or an escrow agent to hold as security? What if the landlord has lost the original letter of credit? Does the letter of credit expressly address this scenario? Under governing rules, who bears this risk, as between the landlord and the issuer?
 - If the original letter of credit is available, the landlord may be surprised to learn that it cannot walk into a local bank branch with the letter and walk out with a briefcase full of cash. Many large banks have only one or two U.S. presentment offices. With stay-at-home orders and other practical hurdles to movement and business-as-usual across the country, how will the landlord achieve presentment at the appropriate office?
 - Some letters of credit allow for the submission of a copy and/or a particular form of draw request; however, as a protection against fraud, those letters of credit may include specific wire instructions for payment. What if the wire instructions are no longer current?
 - What if the lease permits a partial draw, but the issued letter of credit does not permit partial draws and is for an amount greater than what the tenant currently owes?
- **THE BANKRUPT TENANT.** Bankruptcy considerations can factor into a landlord’s handling of security deposits, in a number of ways. If a tenant files for a Chapter 7 liquidation, then the landlord should be able to apply its security deposit without significant delay, since Chapter 7

debtors rarely attempt to preserve their tenancy and lease rejection is the likely result. In such case, typically, the automatic stay will prevent the landlord from setting off the deposit before the lease is rejected, but the lease will most likely be rejected within 60 days. In a Chapter 11 case, the situation is more complex:

- If a tenant files for Chapter 11 protection and the landlord is holding a cash security deposit, then the landlord typically is unable to apply the deposit to the bankrupt tenant's rent without a court order. The landlord will be forced to navigate various road blocks in working out its relationship with the bankrupt tenant. The landlord should not be deprived of the benefit of its security deposit, but unlike a letter of credit, the tenant in bankruptcy has a direct economic interest in its security deposit. A landlord cannot just apply a security deposit to address monetary defaults under the lease by a bankrupt tenant.
- Landlords holding letters of credit with clear contractual rights to present and receive payment (without tenant interference) from the issuer should be able to avoid complications from the tenant's bankruptcy; however, landlords should consult with counsel to assist in assessing the situation before drawing upon a letter of credit after a tenant enters a bankruptcy proceeding.
- In contrast, while a landlord may protect itself by applying a security deposit prior to the bankruptcy filing, once the tenant has filed its Chapter 11 case, a landlord will experience delay and will likely need counsel to assist in addressing when (and if) its security deposit may be applied. These issues are typically driven by whether the tenant eventually decides to assume or reject the lease, or decides to assume and assign the lease to a third-party.
- Commercial landlords also need to be prepared to have the usual rules in tenant bankruptcies reconsidered in light of COVID-19. For example, in the Pier One Chapter 11 case pending in the United States Bankruptcy Court for the Eastern District of Virginia, Richmond Division, Bankruptcy Judge Kevin Huennekens entered an interim order refusing to require current rent payment to certain landlords and imposed a payment deferral that could extend for months since the debtors were forced to shut down their businesses. (Interim Order, dated April 6, 2020.) While this is contrary to the general rule that a debtor needs to remain current on post-petition lease obligations pending an assumption/rejection decision under Bankruptcy Code § 365(a), this pandemic situation and related business disruption may result in unusual rulings adverse to commercial landlords.

In mandating a rent deferral in Pier One, Bankruptcy Judge Huennekens ordered the parties to use "reasonable best efforts to consensually resolve any disputes related to the amount and timing" of rent payments. Whether in bankruptcy court or civil court, judges may have little patience for landlords and tenants who want to litigate rent payment obligations in the face of COVID-19's disruption of business as usual. Moreover, many states have stayed eviction and other lease enforcement efforts by landlords in response to COVID-19. There is some possibility that if a

landlord tries to enforce provisions of a lease in a manner that a judge would deem unreasonable in the face of what many see as the extreme and unusual circumstances arising from the COVID-19 crisis, a tenant may prevail upon the equitable powers of the court for relief. At this point, it is difficult to predict outcomes. So, even where the landlord has the right to apply a security deposit, the landlord will want to weigh the merits of first talking to the tenant and working out a resolution to COVID-19 impacts on the tenant, where possible, before the landlord applies the security deposit for the full amount of the rent due.

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