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Cash Is Not King Anymore

Strategies for Protecting Tenant Assets in Landlord Bankruptcy

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Like many rights in bankruptcy, a commercial tenant's rights to recover assets held by a bankrupt landlord are primarily determined by the negotiated contractual rights under the lease and applicable state law. When representing commercial tenant-creditors, bankruptcy practitioners must adequately gauge avenues for maximizing recoveries. When negotiating commercial leases, real estate practitioners must likewise account for how the Bankruptcy Code's application may impact the character and treatment of commercial-tenant security deposits when a landlord becomes insolvent. This article explores, in the context of a landlord bankruptcy, (1) the characterization, treatment and priority of commercial security deposits; (2) the role that state statutes might play in making such determinations; and (3) strategies for mitigating risks to the recovery of such assets held by nonresidential landlords.

Unexpected Effects of Bankruptcy

An example of how a landlord's bankruptcy may unexpectedly prevent a commercial tenant from recovering its security deposit can be found in Hon. Valerie Caprioni's October 2022 opinion in *10FN Inc. v. Cerberus Business Finance, et. al.* in the U.S. District Court for the Southern District of New York.[2] What began as an adversary proceeding between two nondebtors resulted in the tenant having an unsecured claim for its more than $270,000 security deposit that was paid to the debtor for its sublease of office space in Chicago.

Following the debtor's rejection and after several failed attempts to recover the security deposit, the commercial tenant sought recovery from the debtor-landlord's secured lenders, who — after exercising their rights to sweep the debtor's accounts just prior to the bankruptcy filing — managed to subsume the tenant's security deposit among the swept funds. Upon withdrawing the reference from the bankruptcy court to hear the dispute among the nondebtors, Judge Caprioni found that the tenant-plaintiff failed to state a claim for conversion[3] against the secured lenders because under Illinois law,[4] commercial tenants have no express rights to cash security deposits held by their landlords for securing performance under the lease. This resulted in the tenant's $271,092.87 deposit being deemed an unsecured claim.

In contrast, some state statutes,[5] common law rules or express trust language in the underlying lease agreement may serve to preserve a tenant's ability to recover cash security deposits. In *In re Cold Harbor Associates*,[6] the court found that certain nondefaulting commercial tenants whose security deposits were held by the landlord-debtor were not considered creditors for purposes of determining the number of creditors as of the petition date.[7] In making its determination, the *Cold Harbor* court invoked a rarely cited common law rule set forth by the Virginia Supreme Court, which directs that "until he defaults on his lease terms, a commercial tenant continues to have a full ownership interest in his security deposit and does not merely hold a [contingent] right to repayment."[8]

Likewise, although not arising in the context of a landlord's bankruptcy, the courts in *23 E. 39th Street Management Corp.*,[9] *In re Verus Investment Management*[10] and *In re Timothy Dean Restaurant*[11] serve as examples of the influence that express lease provisions and state statutes will play in determining tenants' rights to recover security deposits. In contrast to *10FN*, the case of *23 E. 39th Street Management Co.* makes clear that because New York has statutorily[12] determined the

1 Disclaimer: The authors do not regularly negotiate or draft commercial lease provisions and therefore present the following merely for informational purposes only. Practitioners should consult applicable law before advising clients on any matters related to the negotiation or drafting of commercial leases.

2 Opinion and Order, *10FN Inc. v. Cerberus Bus. Fin., et. al.*, Case No. 21-5996, 2022 WL 11274633 (S.D.N.Y. 2022) [ECF No. 78].

3 The plaintiff also asserted claims for unjust enrichment against the lenders and negligence against certain executives of the defendants, which were also dismissed for failure to state a claim. *10FN Inc. v. Cerberus Bus. Fin. LLC*, Case No. 21-5996, 2022 WL 11274633, at *6-7 (S.D.N.Y. 2022).

4 Although choice-of-law rules mandated application of New York law to the underlying claims, the terms of the plaintiff's sublease required treatment of the security deposit to be interpreted under Illinois law. *10FN Inc. v. Cerberus Bus. Fin. LLC*, Case No. 21-5996, 2022 WL 11274633, n.10 at *4, *6-7 (S.D.N.Y. 2022).

5 Most states do not regulate security deposits in commercial leases and (as was the case in *10FN*) do not require commercial landlords to segregate security deposits or hold them in trust for the benefit of the tenant. *See generally* Security Deposit Laws (Commercial Lease): State Comparison Chart, Practical Law Checklist w-024-5140. However, a small number of states have enacted statutes or regulations that may govern commercial security deposits to some extent. For example, New York has enacted nonwaivable conditions for how all landlords of rental or real property must hold security deposits, which retain certain possessory rights in the deposits for tenants, in addition to providing the general parameters for the retention or return of deposits. *See* N.Y. Gen. Oblig. Law § 7-103 (McKinney). In comparison, California has enacted similar laws that govern the treatment of cash security deposits, but it has separated residential tenancies from commercial ones, and provides great leeway for commercial parties to waive the statutory requirements. *See* Cal. Civ. C. § 1950.7; *see generally In re Art & Architecture Books of the 21st Century*, 518 B.R. 43 (Bankr. C.D. Cal. 2014) (debtor-tenant waived rights to seek relief from forfeiture and right to redeem its right of occupancy after termination).

6 *In re Cold Harbor Assocs. LP*, 204 B.R. 904 (Bankr. E.D. Va. 1997).

7 *Id.* at 913.

8 *Id.*

9 *23 E. 39th St. Mgmt. Corp. v. 23 E. 39th St. Dev. LLC*, No. 117303/08, 2011 N.Y. Slip Op. 51390(U), 936 N.Y.S.2d 61 (Sup. Ct. 2011); *aff'd*, 23 N.Y.S.3d 33 (N.Y. App. Div. 2015).

10 *In re Verus Inv. Mgmt. LLC*, 344 B.R. 536 (Bankr. N.D. Ohio 2006).

11 *In re Timothy Dean Rest. & Bar*, 342 B.R. 1 (Bankr. D.D.C. 2006).

12 N.Y. Gen. Oblig. Law § 7-103 (McKinney).

legal relationship between a landlord and tenant to be "trustee-*cestui que* trust," commercial tenants in New York may sustain an action for conversion where a landlord fails to segregate a security deposit from other funds.[13]

Both courts in *In re Verus Investment Management*[14] and *In re Timothy Dean Restaurant*[15] found that perfected security interests had been properly created via certain provisions of their respective lease agreements. In *Verus*, the bankruptcy court found that a landlord's security interest in a $1.8 million (uncertificated) certificate of deposit, which was used as the tenant's security deposit, had been properly created by operation of Ohio's version of the Uniform Commercial Code and certain lease language. In addition, its interest remained perfected through a subsequent assignment without any additional filing by the assignee.[16] In *Timothy Dean Restaurant*, the language in a debtor's restaurant lease with its hotel-landlord, which required the landlord to hold the security deposit in an interest-bearing account and return the deposit (plus interest) to the debtor once it had fully performed its obligations under the lease, created an "express trust" under applicable District of Columbia law that also barred setoff by the landlord.[17] These decisions perfectly illustrate the varying outcomes for commercial tenants seeking to protect their interests in security deposits, and the critical importance of understanding the extent to which state law and lease language impact the chances of recovery against a bankrupt landlord.[18]

Considerations for Drafting Commercial Leases

Notwithstanding the limited statutory protections for tenants, there are several appealing equivalents and alternatives to cash security deposits to keep in mind while negotiating and drafting commercial leases. Examples of cash equivalents include pledged certificates of deposit or letters of credit. In addition, cash equivalents may involve a guaranty, some other form of collateral or any combination thereof.

Letters of credit may mitigate the risks of losing a security deposit because they rest on the stability of the issuer rather than the tenant's access to acceptable collateral, and arguably lessen the potential for misappropriation by insolvent landlords. Negotiated provisions in a standby letter of credit may include — but are not limited to — evergreen provisions for automatic renewal; obligations to provide notice of, or conditions on how or when, the landlord may draw upon the letter; and mechanisms for replenishment, burndown or substitution over time. While the provisions can be more challenging to negotiate, partially because of the additional party involved, one of the largest benefits to a letter of credit in the context of bankruptcy is that it does not directly expose the tenant's cash to the risk of diminution as an unsecured claim. That said, letters of credit also serve as a strong benefit to landlords in the event of a tenant bankruptcy because the contractual rights to draw on them will likely — depending on the specific provisions — exist beyond the scope of the automatic stay.[19] Accordingly, tenants who negotiate standby letters of credit should be advised by experienced counsel on the risks and benefits that come along with executing such instruments in lieu of cash.

Another option may involve including trust language in the lease that may, to some extent, protect a tenant's security deposit by retaining a possessory interest in the deposit. However, while this use of cash may be preferable to use without trust guarantees — where commercial leases provide adequate trust language but fail to provide for the *segregation* of security deposit funds — many jurisdictions have adopted the "lowest intermediate balance rule." Depending on the circumstances, this rule may either serve as a basis to exempt the comingled funds from the bankruptcy estate or limit the tenant's right to recover the lowest intermediate balance after the account expends some or all of the funds held in trust.[20] Providing cash for use in a security deposit is almost always riskier for a tenant than providing a cash equivalent. It is imperative that tenants' attorneys carefully consider the possibility of a landlord's insolvency and the risks to a cash security deposit — a commodity whose status as "king" may well now be usurped by more predictable collateral in a bankruptcy case.

Conclusion

As most jurisdictions do not offer any statutory scheme, let alone a strict one, it falls on the parties (or, more accurately, their attorneys) to ensure that lease provisions are clearly set forth and will predictably govern the treatment of commercial security deposits or alternatives, lest sacrificing priority, amount or even approval of a creditor's claim against a debtor's estate. It is no secret that risk is a primary factor when negotiating the terms of a commercial lease. However, the risk that attaches to the possibility of a landlord's insolvency arguably outweighs the risks associated with a tenant's bankruptcy.

In the event of a tenant's insolvency, cash paid to landlords at or before the execution of a commercial lease will almost certainly become property of the debtor's estate.[21] In most jurisdictions, the lease language will generally direct the ultimate disposition of such interests, but when insolvent landlords enter bankruptcy, their cash on hand becomes a finite resource — one that multiple creditors may be competing to claim. If some or all of a landlord's liquidity includes cash security deposits, then tenants

13 *23 E. 39th St. Mgmt.*, *slip op.* at *5.
14 *In re Verus Inv. Mgmt. LLC*, 344 B.R. 536 (Bankr. N.D. Ohio 2006).
15 *In re Timothy Dean Rest. & Bar*, 342 B.R. 1 (Bankr. D.D.C. 2006).
16 *In re Verus Inv. Mgmt. LLC*, 344 B.R. at 546.
17 *In re Timothy Dean Rest. & Bar*, 342 B.R. at 10.
18 *But see, e.g., In re Art & Architecture Books of the 21st Century*, 518 B.R. 43 (Bankr. C.D. Cal. 2014) (under lease, debtor-tenant waived rights to relief from forfeiture and right to redeem its right of occupancy after termination).
19 The obvious trade-off being that they also carry with them the risk of encumbering a tenant-debtor's estate if drawn on post-petition. *See, e.g., In re Senior Care Ctrs. LLC*, 607 B.R. 580, 597 (Bankr. N.D. Tex. 2019) (landlord-creditors could encumber estate post-petition by drawing on $2.7 million in letters of credit on assumed leases for 22 skilled-nursing homes). Additional concerns arise from the so-called "independence principle," which imposes an absolute duty on the issuer to pay, regardless of whether the parties perform on the underlying lease. *See Great Wall De Venezuela C.A. v. Interaudi Bank*, 117 F. Supp. 3d 474, 485 (S.D.N.Y. 2015).
20 *See, e.g., In re Columbia Gas Sys. Inc.*, 997 F.2d 1039, 1063 (3d Cir. 1993) (limiting distribution to $3.3 million of pre-petition cash); *In re Mississippi Valley Livestock Inc.*, 745 F.3d 299, 308-09 (7th Cir. 2014) (failure to trace trust funds and determine lowest intermediate balance warranted reversal and remand).
21 *But see* 11 U.S.C. § 541(b)(2) (excluding certain interests of commercial lessees).

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should expect to find themselves at odds with secured lenders or others who may be more likely to obtain higher-priority distributions.

Moreover, understanding the treatment of commercial security deposits in the applicable jurisdiction and proactively amending leases may ultimately aid in navigating the best course for protecting potential tenant-creditors and will likely influence whether to exercise their rights to retain possession of a leasehold — in the event of a rejection by the landlord — or treat the lease as terminated and walk away with whatever damages can be recovered from the estate.[22] It is imperative that the rights of commercial tenants be carefully considered at all stages of dealing to ensure that a landlord's insolvency does not result in the forfeiture of critical cash. abi

22 The mechanics of the rights retained by tenants under a lease rejected by a landlord-debtor are governed by 11 U.S.C. § 365(h).