

Security Deposits and Restaurant Leases



Christopher A. Agostiono, Esq.



Michael D. Rosen, Esq.

High startup costs represent a barrier to entry in many industries, but none more so than in hospitality and retail. One large outlay that confronts most new restaurant operators is the cash security deposit for a lease. While landlords may be quick to demand cash security deposits from restaurant tenants – the more cash the better – a restaurant operator may be well served by suggesting a stand-by letter of credit as an alternative. A letter of credit in lieu of cash frees up capital at a critical point in the lifespan of any restaurant and may provide benefits to both landlords and tenants during the tenure of a long-term retail lease.

Restaurant tenants may also see the benefit of a letter of credit if a landlord becomes insolvent. Commercial landlords are generally allowed to comingle tenants' security deposits with their own funds; therefore, if a landlord encounters financial difficulty its tenants' security deposits are at risk. At any given time, a cash security deposit could be converted by the landlord for its own use or taken by an attaching creditor or the landlord's bank. If the landlord's depository bank is also a secured creditor, the bank could simply reach into the landlord's operating account and take the funds without notice or demand to the tenant. Moreover, if the landlord files for bankruptcy protection, a tenant's claim for return of its security deposit could stand in line with other general unsecured creditors, absent expensive legal wrangling to prove a constructive trust or other priority claim to the funds. It may be possible to address some of these issues in a negotiated subordination, non-disturbance and attornment agreement between the tenant, the landlord and its bank, but a tenant could avoid landlord insolvency issues altogether through use of a letter of credit. So long as the tenant is not in default under the lease, a properly drafted letter of credit should be outside the scope of any claims or liens asserted by landlord's creditors. While these issues may seem remote, turmoil in the real estate market in the not too distant past is proof positive that these possibilities should at the least be understood and considered, depending the landlord in question.

If asked to consider a letter of credit in lieu of cash, Landlords should not be quick to dismiss the idea. A landlord's primary motivation in seeking security under a lease agreement is to ensure payment in the event its tenant becomes insolvent. Insolvency laws, including bankruptcy, may delay, limit or altogether prohibit a landlord from actually taking cash held as a security deposit in satisfaction of a tenant's debt. The problem lies in the fact that a security deposit remains property of the tenant despite the fact it is paid over to and held by the landlord. As tenant's property, the security deposit is part of the bankruptcy estate and therefore subject to the automatic stay triggered by a tenant's bankruptcy. Without relief from the bankruptcy court, the landlord cannot use the tenant's funds. Even if the landlord has a perfected priority security interest in the tenant's security deposit, by virtue of its possession of the funds or otherwise, taking such funds without court approval could be deemed a violation of the automatic stay and subject the landlord to penalties. Furthermore, to the extent the landlord applied its tenant's security deposit prior to the tenant's bankruptcy, any funds collected in the ninety days prior to the bankruptcy filing could be recouped by a debtor in possession or bankruptcy trustee as preferential transfers.

Alternatively, if the landlord had obtained a letter of credit in support of tenant's obligations under a lease, the landlord could present the letter of credit directly to the issuing bank, which would obligate the bank to pay the landlord's claim pursuant to the terms of the letter of credit. Generally, amounts received by the landlord directly from the issuing bank are treated like payments received from a guarantor and may not be subject to any preferential transfer action or otherwise require a bankruptcy court's permission before receipt. This analysis is not conclusive in some courts, and other courts including the First Circuit, have not established precedent on this issue yet. Nevertheless, a carefully drafted lease and letter of credit may increase the likelihood that a landlord may freely exercise its rights in the event of tenant's bankruptcy.

Entrepreneurial restaurateurs generally do not consider insolvency issues at the outset, but if the conversation with a landlord turns to the security deposit, it is important to have a basic understanding of the underlying issues. The drafting and negotiation of a letter of credit may add transaction time and cost, but the potential to finance what would otherwise be a large up-front cash expenditure might make economic sense and should not be ignored. At the very least, a restaurant tenant should consider the specifics of any particular lease transaction before proposing a cash security deposit over a letter of credit.

Michael D. Rosen, Esq. is a partner in the Corporate and Business Law Group at Ruberto, Israel & Weiner, P.C., and chairs the firm's Commercial Real Estate Practice Group. Among other areas, his practice includes representation of real estate developers, owners and lessees in a variety of complex transactions, commercial leasing and bankruptcy.

Christopher R. Agostino, Esq. is an associate in the Corporate and Business Law Group at Ruberto, Israel & Weiner, P.C. Among other areas, his practice includes representation of commercial landlords and tenants as well as creditors rights in bankruptcy.

Michael D. Rosen is a shareholder of Ruberto, Israel & Weiner, and a member of the firm's Hospitality & Retail Services and Banking, Finance & Lending Groups, and Chair of the Commercial Real Estate Group. Michael can be reached at mdr@riw.com.