

REAL ESTATE

# Lease Security Deposits Might Not Be So Secure

**Joshua Stein** Contributor *I write about commercial real estate negotiations, deals and legal issues.*

Dec 7, 2022, 10:00am EST

Tenants often deliver substantial security deposits when they sign leases. Those deposits are supposed to secure the tenant's obligations. At the end of the lease, if the tenant has properly behaved, the landlord should return the security deposit to the tenant. It's not the landlord's money, or is it? Maybe it is—if the landlord files bankruptcy.

[A recent New York case](#) considered exactly this sequence of events. A tenant under a lease in Chicago gave the landlord a substantial security deposit. The court found that those funds were, under Illinois law, effectively nothing more than a loan to the landlord. When the landlord filed bankruptcy, the tenant had the same rights as any other creditor that lacked security for its claim. In this case, that meant the tenant would recover very little on account of its unintended loan to the landlord.

The court based its decision in part on the words of the lease itself. The lease required the tenant to post and maintain a security deposit. It said nothing, though, about ownership of the security deposit or how the landlord was supposed to hold it. Nowhere did the landlord agree to hold

the security deposit in trust, a segregated account, or any other special way.

The lease just said the landlord would return the deposit (minus any proper offsets) to the tenant 30 days after the lease expired. As a result, the deposit was simply money that the tenant gave the landlord that the landlord was supposed to give back later—functionally nothing more than a loan.

Some states set a higher standard for how a landlord deals with a security deposit. In New York, for example, the landlord must hold the security deposit in trust in a separate account for the benefit of the tenant. By law, the deposit remains the money of the tenant, not the landlord.

Unfortunately for the tenant in this particular case, however, Illinois doesn't have a statute like New York's, at least for commercial tenants. (Illinois does, however, have protections for residential security deposits.) That meant the landlord could freely commingle the security deposit with its other funds. When the landlord filed bankruptcy, the security deposit was just more money in the landlord's hands. The tenant's claim for its security deposit was just another claim in the bankruptcy, entitled to payment of pennies on the dollar if that.



This sad saga teaches tenants that when they deliver security deposits under leases, especially substantial security deposits, they should give

some thought to the legal protections for those security deposits. Favorable lease language helps, as does favorable state law. If any uncertainty remains and the tenant has any negotiating leverage, however, the tenant might insist on establishing an escrow or similar arrangement to protect the security deposit. This is especially true if the tenant has reason to believe that the landlord may soon suffer financial problems or go bankrupt.

In the litigation described in this article, the landlord was actually a tech company that was a sublandlord, not a property owner. The tech company entered into the sublease because it didn't need all the space it had leased, and it was shrinking. Those facts alone probably should have set off alarm bells for the tenant.



**Joshua Stein**

Copyright © 2022 Joshua Stein. Published on Forbes.com December 7, 2022.

I help buyers, sellers, borrowers, lenders, tenants, property owners, and other commercial real estate market participants identify and achieve their business goals. To do that, I need to understand risk, security, numbers, value, financeability, flexibility, and exit strategy. Some legal issues matter a lot and many don't. It's important to know the difference. I write extensively on commercial real estate law and practice – over 300 articles and five books on leasing, lending, and other areas, with some emphasis on ground leases. I occasionally serve as an arbitrator or expert witness in complex real estate disputes. That lets me see how transactions go wrong. Often, the problems could have been avoided by keeping it simple and following the money, but everyone got sidetracked. As a Forbes contributor, I try to tell stories that teach worthwhile lessons for real estate deals. **Read Less**