

Negotiate Alternative to Cash Security Deposit

While the economy has steadily improved in many areas, it's still important to protect yourself from the perils of a bankrupt tenant. When negotiating with a prospective tenant—especially one that's small or not financially strong—keep in mind that if it experiences financial problems the security deposit could wind up being your only access to funds that can compensate you if the tenant stops paying rent or otherwise breaches the lease. A cash security deposit can leave you vulnerable in the event of a tenant's bankruptcy. To protect yourself, consider a more reliable alternative: a letter of credit (LOC) security deposit.

Trend Toward LOCs

Owners have been increasingly favoring letters of credit rather than cash as security from tenants, says New York attorney Sujata Yalamanchili. She attributes the uptick in negotiating for an LOC to recent court rulings that have determined that cash put up by commercial tenants may not be readily available to the owner and may instead be treated as part of the tenant's bankruptcy estate, leaving the owner standing in line with other creditors for that money.

“Even though the lease specified that the cash was to be used as a security deposit, some courts still treated it as part of the general funds of the tenant, essentially making it available for all creditors of the tenant,” Yalamanchili explains.

Yalamanchili points out that an LOC should be more secure because, unlike a cash security deposit, it isn't an obligation of the tenant. Technically, it's not the tenant's money; it's the obligation of a third party to pay the owner a certain amount of money upon a certain event, such as a breach of the lease.

Consider LOC, Other Options

Using an LOC isn't totally risk-free, but there have been enough court cases ruling that an LOC isn't part of the tenant's bankruptcy estate to make it worth considering. Consult with your attorney about whether this is a good option for you.

“There's certainly less risk since an LOC should not be considered part of the tenant's bankruptcy estate, and therefore, it should be available to the owner as security,” says Yalamanchili, who finds that this trend is prevalent in big cities and more urban areas, while small town owners are still accepting cash deposits. The amount of the security deposit may also be a determining factor, with LOCs being required for deposits of more than six months' rent.

Another litmus test for LOCs is how high the stakes are for the owner of the space the tenant will rent. “The more the owner has to lose if it doesn't have an LOC that's more secure than cash, the more likely it'll negotiate for a letter rather than cash,” notes Yalamanchili.

If an LOC isn't the best option for you, you don't necessarily have to settle for cash. Depending on the nature of the lease deal, aside from an LOC, the tried and true personal guaranty or a corporate guaranty from a parent company is a possibility. Certain deals will also dictate what form of security deposit is customary. For example, in the case of a franchise tenant, it's routine to require a parent company guaranty or a franchisor guaranty, Yalamanchili points out. ♦

Insider Source

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