

# SECURITY DEPOSIT: TBD – NEITHER A GOOD IDEA NOR NECESSARY

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Typically, when I receive a letter of intent (“LOI”) for a lease transaction, I see one of the following treatments of the all-important security deposit issue:

“Security Deposit – TBD”

Or

“Security Deposit – Subject to Tenant’s Financials.”

Perhaps the well-meaning brokers are trying to get agreement on the base lease terms (rent, term, TI, options), while leaving the more complex issues for the parties or their lawyers to handle when the lease is drafted. This practice can be a mistake, putting the deal at risk in the late stages, or putting the tenant in a weak position when the security deposit issue is finally addressed. The following “war story” illustrates my point.

I was pleased to represent an office tenant (“T”) on its 10-year lease of 20,000 square feet of space in suburban Chicago. The property was a Class A building with precious little vacant space, owned by an experienced institutional investor. Both parties were mo-

tivated to make the deal, as evidenced by the landlord’s (“LL”) concessions of 10 months’ of free rent and a generous tenant improvement allowance. However, the LOI read: “Security Deposit – subject to Tenant’s financials.”

When I saw this provision, I advised my T client to provide its financial statements right away. I recommended that we could negotiate the security deposit issue early in the process. If LL wanted to require a substantial security deposit, then T would still have time before expiration of its present lease term to find an alternative space, or at least use an alternative deal as leverage to negotiate a lower security deposit. My repeated warnings were not heeded, and after negotiation of the entire lease except for the security deposit amount, T finally produced its financials to LL. You probably saw this coming: LL indicated the financials were “weak” and required a large (4 months of gross rent) security deposit, and adjusted the abated rent provision substantially. The free rent was changed from months 1-10 to months 25-34. LL insisted that no free rent would be allowed unless T paid its

first 24 months’ rent timely. Moreover, if T defaulted and failed to pay rent thereafter, beyond the applicable monetary default cure period, LL could recover ALL abated rent and ALL of the TI costs.

At this point, T had no alternative but to accept the terms in order to vacate its existing space timely and avoid holdover rent. This new lease was more expensive up front, with a large security deposit and no immediate free rent. The broker, and my client, had “Kicked the Security Deposit Can Down the Road” and paid dearly for it. I noted that the abated rent was a larger concession in months 25-34, because base rent in year three was higher than in year one, but this was a small consolation. Could we have handled the open issue and security deposit differently? Of course, hence this article.

Here are a few ideas for addressing the thorny but always important issue of Security Deposits.

**1. Address the issue EARLY:** Don’t let the parties (especially T) get so invested in the deal that it has no alternative and therefore little to no leverage.

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“ There are many ways to skin the security deposit cat, and most techniques are successful in the end. However, early treatment of the security deposit issue is a must, even if it kills the deal. ”

2. **Offer Burn-off:** If the LL insists on a large cash security deposit and T must produce it, request that portions of the security deposit “burn off” and be applied to rent, if and when a period of time passes and T has paid its rent timely during that period. When advocating for T’s burn-off, I remind LL that this provides additional incentive for T to pay its rent timely.

3. **Letter of Credit Instead of Cash:** This could be the rare “win/win,” when T doesn’t want to (or cannot) post a large security deposit. T offers an irrevocable letter of credit in lieu of cash. While there is an up-front cost to T, that cost may be preferable to putting extra cash in LL’s hands. For example, if LL loses the building in foreclosure, in most cases the security deposit, if not escrowed by LL in a separate account, is lost and neither the lender nor the receiver has any obligation to refund a security deposit it doesn’t hold. On the other hand, in the event of a T bankruptcy, LL doesn’t keep the security deposit; it goes back to the T debtor’s estate. A L/C, however, solves LL’s problem. LL collects from T’s bank which issued the L/C, and the bank now faces the problem of collection.

4. **L/C and Burn-off:** Consider this combination. Start with a L/C in a larger amount, but then the amount of the L/C (usually renewed annually) could be reduced or burned off if the parties so negotiate, and if T pays all rent timely.

5. **Personal Guaranty:** This is another tool in the tool box to help on the security deposit issue. The guarantee of a wealthy individual principal of the T firm (and his/her spouse) might help reduce the amount of cash required by LL, and the guarantee could also burn off over time if T pays rent timely.

I looked at a lease LOI recently while representing an LL. The LOI was open on the security deposit, while T wanted three months of free rent on a two-year term and a TI allowance (paint and carpet), and T resisted LL’s right to recover abated rent and TI costs if T defaulted. What’s more, T refused to provide a personal guaranty. Even LL’s offer of burn-off of the larger security deposit (three months) was refused by T.

LL’s CFO asked me to do a background check on T and its principal. T’s finances seemed marginally OK, but then we found 10 lawsuits in the last eight years in Cook County alone! Five had T or its principal as defendant, and the other five had T or its principal as plaintiff. Would you, as LL, want that T? By the way, our search also revealed that T’s principal drove a high- end Italian sports car, and that his mechanic successfully sued the principal (judgment entered) for unpaid repair costs. Fortunately, this unsuccessful negotiation took only two weeks, time enough for my LL client to say “No thanks, we are moving in a different direction,” and continue its search for a different and more reliable tenant.

There are many ways to skin the security deposit cat, and most techniques are successful in the end. However, early treatment of the security deposit issue is a must, even if it kills the deal. Enough said! ♥