Finkelstein Newman LLP

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Newsletter

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SECURING SECURITY DEPOSITS: RIGHTS AND RESPONSIBILITIES

In *McMaster v. Pearse*, a recent decision issued by Judge Diane Lebedeff of the New York County Civil Court, landlords were reminded to comply with three requirements when holding their tenants' security deposits. In the event of noncompliance, a tenant will be permitted to recover these funds from a landlord despite any lease related breach committed by the occupants.

First, landlords have a duty to hold these proceeds in a manner that will distinguish them from personal funds. Courts look to whether the monies are held in a segregated account in the landlord's name "as trustee" or whether the funds are otherwise appropriately held and labeled as security deposits. For example, appellate courts have held that placing a cash security deposit in a sealed envelope containing a signed and witnessed letter indicating that the monies comprised a particular tenant's security complied with the law. However, a combining or "commingling" of a security deposit with a landlord's personal funds is considered a form of theft or "conversion" that requires the landlord to immediately return the funds to the tenant.

Second, whenever a landlord deposits a tenant's security deposit with a bank, the landlord has an independent obligation to provide the tenant with written notice of the institution's name, address, account number and the deposit amount. Since a lease provision identifying the bank or a cancelled check stamped with the data will not suffice, a separate written letter or notice detailing the deposit particulars is the only acceptable way to satisfy this requirement and to avoid a presumption that a commingling has occurred.

Third, landlords are required to respond when tenants seek information regarding the status of their security deposits. By way of example, a tenant's request for an account history should be honored. Failure to answer sufficiently or reasonably promptly may trigger an inference of "commingling" which could ultimately lead to the return of the tenant's funds. Pursuant to this rule, if the tenant raises a maintenance inquiry–such as whether security deposit monies have been commingled with a landlord's personal funds–it is not sufficient for the landlord to advise, in a conclusory manner, that the monies are held in a bank account reserved exclusively for the property in question. Rather, the landlord must provide specific account related information so that the tenant may be assured that non-trust funds are not being combined with security proceeds.

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SECURING SECURITY DEPOSITS: RIGHTS AND RESPONSIBILITIES

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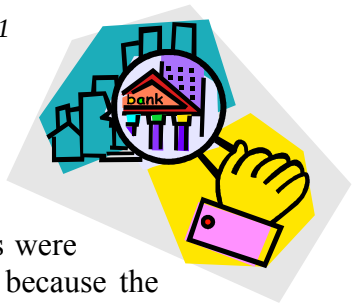

Judge Lebedeff's case is unique because it also addressed the issue of liability when multiple property owners are involved. Although a husband and wife co-owned the property, the security deposit was held in a bank account bearing the husband's name. That violated the first of the three requirements we examined earlier, because the funds were not held in a segregated account or in some other distinguishing manner. However, because the husband died prior to the litigation's commencement, the question addressed by the court was whether the surviving spouse shared responsibility for the violation. According to Judge Lebedeff, the answer was "yes," based on co-ownership and joint liability grounds. Co-owners each have the obligation to hold security deposits "as trustee" and can each be held liable for the other's inaction or wrongdoing. As a result, the surviving party was ordered to release the monies to the tenant.

The lesson learned from this case is that property owners should exercise caution with respect to security proceeds so that the penalties that flow from commingling may be avoided. By contrast, tenants should be aware of these protections and inquire of their landlords as to where and how their security deposits are being held in order to ensure that these monies are appropriately safeguarded.

If you have any questions or concerns about this recent case, please contact senior partner Daniel Finkelstein at 212-619-5400 x 209 or email him at DFinkelstein@FinkelsteinNewman.com.

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UPCOMING SEMINAR

FEBRUARY 28, 2006

Hot Topics in Landlord-Tenant: 2006 Update

On Tuesday, February 28, 2006, from 6:00 P.M. to 9:00 P.M., partner Lucas A. Ferrara, will be a featured speaker at a continuing legal education ("CLE") seminar sponsored by New York County Lawyers' Association.

ISSUES ON THE AGENDA

- "She's So Unusual": Was Cyndi Lauper Overcharged?
- Actual Partial Evictions: How Much is Too Much?
- "Illegal Sublets": Roommates & Immediate Family Members
- Video Surveillance: Security Pretext, Harassment Subtext?
- Discriminating Co-ops: Don't Tread on the Unmarried!
- Applying RPAPL § 745(2): Motion = Adjournment ≠ Use & Occupancy?
- Use Clause Violations: Are "Child Care" Providers Entitled to a Free Pass?
- Contract Representations: When Can You Believe What You Read?

CONTINUING EDUCATION CREDITS:

- 3 MCLE Credits
- 3 Professional Practice
- Transitional

For pricing information, or to register for this course, please contact New York County Lawyers' Association's CLE Institute at (212) 267-6646, or at www.NYCLA.org.

BANKRUPTCY CODE CHANGES IMPACT L&T

On October 17, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") went into effect with significant changes which impact the world of landlord-tenant practice.

"Automatic Stay"—Not So Automatic Anymore

It is virtually common knowledge that a mere filing of a bankruptcy petition operates as an "automatic stay" against most collection efforts. Once a debtor initiates the process and files for bankruptcy, this statutory protection immediately freezes most lawsuits filed against the debtor, and enjoins creditors, collection agencies, or government entities from collecting sums (including rent arrears) that may be due. Its purpose is to prevent creditors from interfering with the debtor's financial reorganization and to provide the debtor with an opportunity to rehabilitate and formulate a plan or allow for an orderly liquidation of the debtor's assets. A creditor who violates the automatic stay may suffer contempt related sanctions, which could include incarceration, actual damages such as costs and attorneys' fees, as well as punitive damages in certain circumstances. Thus, the stay is a powerful tool that preserves the *status quo* while the debtor's affairs are sorted out.

As its name suggests, BAPCPA was enacted because Congress sought to address a noticeable increase in abusive bankruptcy filings. In the past, the process had been known to attract individuals who disregarded the law's eligibility requirements. Although aware that they did not qualify for relief under the Bankruptcy Code, some debtors nevertheless filed bankruptcy petitions in order to obtain the protections of the automatic stay. Within the landlord-tenant context, a tenant could assert a vigorous defense to a summary proceeding, exhaust all civil court remedies, have a money judgment and final judgment of possession issued against it, file a bankruptcy petition prior to eviction and freeze the enforcement of those judgments. Prior to the BAPCPA's enactment, the landlord would be stayed from taking any action until relief from the automatic stay was granted, usually after notice and hearing, by the Bankruptcy Court. Even when the debtor had no possibility of ultimately reorganizing, restructuring, or otherwise preserving its tenancy, the prior law caused landlords to suffer significant time delays, rental income-loss, and legal fee expenditures.

And prior to the changes made by the BAPCPA, the automatic stay applied to most landlord-tenant situations, other than a landlord's efforts to recover possession of commercial property after expiration of the stated lease term. For residential tenants, or commercial tenants with a continuing lease, landlords could not commence or proceed with a case, or enforce a state court judgment, until the automatic stay was lifted by Bankruptcy Court order. Meaning, a landlord seeking to recover possession of property prior to conclusion of the bankruptcy proceeding would have to move the bankruptcy court for relief from the automatic stay either for "cause," (such as the debtor having failed to pay rent accruing after the bankruptcy proceeding had been filed), or on the ground that the debtor lacked equity in the property and that the property was not necessary for an effective reorganization. Only after this motion was granted and the stay lifted, could a landlord begin or continue with the state court eviction process.

Under the new amendments to the Bankruptcy Code, state court eviction proceedings against residential tenants may continue if the landlord has obtained a judgment of possession prior to the bankruptcy petition's filing. However, a tenant may still secure a stay and remain in possession if the tenant has the right to cure the pre-bankruptcy lease default. A residential tenant who files a bankruptcy petition after a judgment of possession has been entered must, in order to obtain a stay, serve and file a sworn certification that circumstances exist under applicable nonbankruptcy law that permit the tenant to cure the default that gave rise to the possessory judgment, and that the tenant has deposited with the court the rent that would be due during the 30-day period after the bankruptcy petition's filing. The new Bankruptcy Code amendments further provide that a tenant has 30 days to file an additional sworn certification that the default has been cured. In short, under the new Bankruptcy Code amendments, a residential tenant who files a bankruptcy proceeding after a judgment of possession has been entered in State court now bears the burden of proving that the automatic stay applies.

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Also new to the Bankruptcy Code is the stay's inapplicability when the tenant has endangered the property or has engaged in the illegal use of controlled substances. In these latter instances, the landlord must file a certification with the court that the prohibited behavior occurred within 30 days prior to the tenant's bankruptcy filing.

Unfortunately, these new Code provisions do not apply to all circumstances and only govern when a residential tenant has filed a bankruptcy petition after a judgment of possession has been entered, has endangered the property or has engaged in illegal use of controlled substances. Thus, in light of the ambiguities that still exist, it is of critical importance to consult with counsel prior to taking any action that could be deemed violative of the new law.

"To Assume or Reject?" – No Longer An Open Question

While there are some uncertainties regarding the automatic stay under the new Code, the modifications impacting the assumption or rejection of commercial leases are more straightforward. The Code contains statutory deadlines for a debtor to "assume or reject" executory contracts and leases. Previously, if the debtor did not assume a commercial lease within 60 days after filing a bankruptcy petition, the lease was deemed rejected. Within that 60-day period, the debtor had the opportunity to request more time from the court. Courts were free to grant an extension, or even a successive series of extensions, without any specific statutory time-constraints. Under the new Code, however, this practice has been curtailed. If the tenant does not assume or reject a commercial lease within the first 120 days of the case, the lease is deemed rejected and the landlord may regain possession. While the debtor may still request an extension of this 120-day period, now the court's grant of more time is limited to an additional 90 days. Thereafter, any further extensions require the landlord's written consent.

If you have any comments or questions about this article, or a bankruptcy related question, please contact Melissa Ephron-Mandel at 212-619-5400 x 229 or email her at MEphron-Mandel@FinkelsteinNewman.com.

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