

LEASE SECURITY DEPOSITS IN NEW JERSEY

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OVERVIEW:

Generally, a security deposit is a landlord's security for the tenant's performance of its obligations under the lease. In the event the tenant does not uphold the tenant's responsibilities under the lease, the security deposit can be a remedy for the landlord. In New Jersey, there are strict rules for the collection, retention and return of security deposits held by landlords in connection with residential leases. Unlike residential leases, security deposits in commercial leases are a matter of negotiation between the parties.

COMMERCIAL LEASES:

The amount of the security deposit in commercial leases can be influenced by many factors including the amount of rent being paid by the tenant, the amount of up-front investment to be made by the landlord and the financial strength of the tenant and any guarantors. The parties should consider the following in reviewing the security deposit in a lease:

- ▶ Will the landlord be obligated to keep the security deposit in a separate account? Practically, most commercial landlords want flexibility to commingle the security deposit with other accounts.
- ▶ Will the security deposit be maintained in an interest bearing account and will the tenant be entitled to the interest? Commercial landlords take the position that the tenant is not entitled to the interest on the security deposit if it is maintained in an interest bearing account.
- ▶ What is the security deposit intended to protect? Commercial landlords want the right to use the security deposit to secure any and all tenant obligations under the lease. Alternatives include restricting the use of the security deposit to secure only monetary terms, like rent or damage to the leased premises. Tenants should be wary that broader coverage of all claims by the security deposit will permit a commercial landlord to use the remedy as a means of "self-help."
- ▶ Will the application of the security deposit to a tenant default cure the default? In negotiating the security deposit, commercial tenants may want to include provisions that the application of the security deposit will be considered the landlord's election to cure the tenant default and therefore, the landlord is then prohibited from terminating the lease or evicting the tenant.
- ▶ Will the tenant be required to replenish the security deposit in the event the Landlord applies all or a portion of the security deposit to a breach? Consistent with the application of the security deposit to cure a breach, commercial landlords will require the tenant to immediately replace the funds previously applied. This can result in multiple breaches under the lease in the event the tenant defaults and then fails to replenish the deposit.

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- ▶ What will be the form of the security deposit? Most security deposits will be in the form of cash security or a letter of credit. While letters of credit can be adequate security, the landlord will want to consider: (i) what bank is issuing the letter of credit and its creditworthiness; (ii) whether the letter of credit is irrevocable; (iii) whether a partial draw on the letter may be made; (iv) the term of the letter of credit, which should extend for a period beyond the lease expiration; and (v) what documentation and acts are required by the bank to release the money to the landlord. Letters of credit also have an added benefit as they are not considered part of the tenant's estate in the event the tenant declares bankruptcy. This means that, unlike the cash security deposit, the letter of credit is not subject to restrictions of the bankruptcy automatic stay.
- ▶ Will any portion of the security deposit be released during the term of the lease? Some tenants are able to negotiate "good boy" provisions allowing a portion or all of the security to be released if all payments to the landlord are made on time for a set period. For example, if all rent payments are timely made for two years, half of the security deposit may be returned to tenant.

RESIDENTIAL LEASES:

Unlike commercial leases, the security deposit in a residential lease is governed by the Security Deposit Law, NJS §46:8-19 et seq. The Security Deposit Law applies to the rental of all premises used for dwelling purposes pursuant to a lease, contract or license except owner occupied premises with not more than two rental units. Unlike commercial leases, where the security deposit provisions are negotiated, residential landlords are limited by the

Security Deposit Law to the following:

- ▶ The landlord may not collect more than 1½ times the monthly rent as security.
- ▶ If the residential Landlord is receiving deposit money from ten (10) or more units, the landlord must invest the money in an insured money market or deposit the money in a variable rate account at a state or federally chartered bank. Residential landlords receiving deposits for less than ten (10) rental units are required to deposit the money in a state or federally chartered bank in an account bearing interest on time or savings deposits. Landlords of seasonal rentals (rentals for a term of 125 days or less by a person with a permanent place of residence elsewhere) are not required to comply with the Security Deposit Law investment requirements.
- ▶ Interest on the deposit belongs to the tenant.
- ▶ Residential landlords are not permitted to commingle the deposit money with other accounts.
- ▶ Residential landlords are required to give each tenant a statement notifying the tenant of the location of the security deposit within 30 days of receipt of the deposit. In the event the landlord fails to notify the tenant of the location of the deposit, the tenant may require that the security deposit plus 7% interest per

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year be applied toward any rent due and owing as a penalty.

- ▶ Residential landlords are required to return the tenant's security deposit within 30 days after termination of the lease along with the tenant's portion of the interest.

Security deposits are typically assigned in the event of the sale of the leased property. The new owner should be responsible to each tenant for the full amount of the tenant's deposit, and in the residential setting, the new owner will be responsible whether the new owner is the assigned the security deposit or not at closing. Residential landlords need to be careful to comply with these rules at lease commencement and on an ongoing basis.

For more information, contact:



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