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## Comment: Security Deposits in New York: How Safe is Your Money?

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# SECURITY DEPOSITS IN NEW YORK: HOW SAFE IS YOUR MONEY?

## I. Introduction

For tenants everywhere, the payment of a security deposit on an apartment lease is an expected but unwelcome formality. To some it is a mere annoyance, while to others it may be a decisive factor in the search for a place to live. For most tenants, it is a payment made with uncertainty, deserving of more than a casual surrender to the fine print of a lease.

In New York, where there has never been a general landlord's statutory or common law lien,<sup>1</sup> the growth of the cities and the consequent legal development of the landlord-tenant relationship has enhanced the importance of the leasehold agreement.<sup>2</sup> In anticipation of an area's growth, real estate owners invest large sums for the creation and maintenance of apartments and offices.<sup>3</sup> With rapid apartment turnover rates and the rise and fall of an uncertain free enterprise system, landlords, seeking protection beyond tenants' personal assurances that the lease will be honored, require a provision for a security deposit in the lease. The protection the landlord deserves, and the fundamental purpose of the deposit, is to secure to the landlord the tenants' compliance with the covenants of the lease.<sup>4</sup>

Whether the landlord-tenant relationship is one of debtor-creditor, pledgor-pledgee, or trustee-cestui que trust, payment of a security deposit has been widely abused for the landlord's gain.<sup>5</sup> Where the tenant's deposit is threatened,<sup>6</sup> it is obvious that a tenant

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1. 1 AMERICAN LAW OF PROPERTY § 3.73 (A.J. Casner ed. 1952).

2. See generally Wilson, *Lease Security Deposits*, 34 COLUM. L. REV. 426 (1934).

3. *Id.*

4. *Id.*

5. See, e.g., cases cited notes 19, 60-63, 66-70 *infra*. See also Harris, *A Reveille to Lessees*, 15 S. CAL. L. REV. 412 (1942).

6. For example, where the landlord converts the money and invests it, or where he has demanded the money as something beyond security, such as the prepayment of rent.

should be afforded protection.<sup>7</sup> Yet in New York this protection remains weak.<sup>8</sup>

The landlord's ill-defined duties as a debtor at common law have been brought into sharper focus by statutes<sup>9</sup> which have made him a trustee of the tenants' money.<sup>10</sup> The landlord's duties include holding security deposits separate from personal funds,<sup>11</sup> and taking certain prescribed measures to protect tenants' money upon conveyance of the fee.<sup>12</sup> Moreover, if the landlord owns a building containing six or more dwelling units, he is required to bank tenants' money and accumulate interest thereon for the tenants' benefit.<sup>13</sup> The Attorney General now has standing to sue and enforce directly all statutory provisions concerning security deposits.<sup>14</sup>

The common law, however, prevails in one important area—the fate of a deposit upon the tenant's breach of a lease.<sup>15</sup> New York courts have attempted to apply certain well-settled principles of fairness to probe parties' intent and minimize the literal language of the lease.<sup>16</sup> Yet problems remain in the area of common law breach and in the application of the statutory provisions.<sup>17</sup>

This Comment will trace the common law in New York, and examine the development of the statutory law. It will indicate certain remaining problems and emphasize certain inequities that deserve legislative scrutiny.

## II. The Security Deposit At Common Law

At common law, New York courts devoted considerable attention

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7. "It is submitted that proper protection of the lessee is thoroughly consistent with equal proper protection of the lessor. The lessor has no right to treat a deposit as his own, nor has he the right to treat it 'as rent,' for, among other things, it is incongruous to collect 'rent' when no attendant use is given of the demised premises." Harris, *supra* note 5, at 424.

8. See text accompanying notes 71-73 *infra*.

9. N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney Supp. 1974).

10. *Id.* §§ 7-103, -105 (McKinney Supp. 1974).

11. *Id.* § 7-103.

12. *Id.* § 7-105.

13. *Id.* § 7-103(2-a).

14. *Id.* § 7-107.

15. See generally *id.* § 7-103.

16. See notes 77-83 *infra* and accompanying text.

17. See notes 60-70, 91-97, 116, 123-27 *infra* and accompanying text.

to the landlord-tenant relationship and to the manner in which this relationship was affected by the tenant's security deposit.<sup>18</sup> When a lessee deposited money with his landlord as security for the performance of a lease, courts held that the relationship created was that of debtor and creditor.<sup>19</sup> These courts further reasoned that the relationship should be governed by the parties' intent. Absent any findings of contrary intention, most courts held that a debtor-creditor relationship was created.<sup>20</sup> A minority, however, found that the deposit of security created a fiduciary relationship between landlord and tenant.<sup>21</sup> Under this theory, a landlord was declared a trustee of tenants' money,<sup>22</sup> the security deposit becoming a trust fund rather than a debt.<sup>23</sup> Since the New York Court of Appeals never ruled definitively on this issue,<sup>24</sup> the conflict continued until resolved by legislation.<sup>25</sup>

As case law developed it became apparent that the landlord enjoyed a favored position before the New York courts.<sup>26</sup> *Mendelson-*

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18. See notes 20-40 *infra* and accompanying text.

19. *Levinson v. Shapiro*, 238 App. Div. 158, 263 N.Y.S. 585 (1st Dep't), *aff'd*, 263 N.Y. 591, 189 N.E. 713 (1933); *Jahmes Co. v. Propper*, 238 App. Div. 326, 264 N.Y.S. 219 (1st Dep't 1933); *Mendelson-Silverman, Inc. v. Malco Trading Corp.*, 146 Misc. 215, 260 N.Y.S. 881 (Sup. Ct. 1932), *aff'd*, 238 App. Div. 852, 262 N.Y.S. 291 (2d Dep't), *aff'd*, 262 N.Y. 621, 188 N.E. 92 (1933).

20. See cases cited note 19 *supra*.

21. See, e.g., *In re Atlas*, 217 App. Div. 38, 216 N.Y.S. 490 (4th Dep't 1926); *Euclid Holding Co. v. Kermaco Realty Co.*, 131 Misc. 466, 227 N.Y.S. 103 (Mun. Ct. 1928); *Alumor Garage, Inc. v. Stivers, Inc.*, 128 Misc. 400, 218 N.Y.S. 683 (Mun. Ct. 1926).

22. See notes 43, 55 *infra* and accompanying text.

23. *Id.*

24. *Cf. Sagone v. Mackey*, 225 N.Y. 594, 122 N.E. 621 (1919) where the court was confronted not with the relationship of landlord-tenant but of principal and agent. The court stated: "We shall pass the proposition which certainly may be argued with much force that the final arrangement under which plaintiff left her moneys with defendant was that of a simple deposit creating the ordinary relation of creditor and debtor . . ." *Id.* at 598, 122 N.E. at 622.

25. See notes 41-44 *infra* and accompanying text.

26. *Cf. In re Banner*, 149 F. 936 (S.D.N.Y. 1907). In this case the tenant deposited five thousand dollars with his landlord as security for the punctual payment and performance of the covenants and agreements of the lease. The lease required the landlord to pay interest on the deposit and

*Silverman, Inc. v. Malco Trading Corp.*<sup>27</sup> involved security deposited to guarantee tenants' faithful performance of the lease covenant. Under its terms the landlord was required to pay interest, and to place the deposit in escrow six months prior to the termination of the agreement. A tenant defaulted on his rental payments and the landlord instituted a summary dispossession proceeding. Upon discovering that the landlord commingled the security with his general funds and diverted it to his own benefit, the tenant counterclaimed for conversion. The Appellate Term, Second Department, in attempting to formulate a general rule stated:

The relation in which the security is to be held is a matter of agreement between the parties. For instance, they might provide in the lease that the security is to be held in trust or in some other fiduciary relation by the landlord. This might be done either by express language or by language which necessarily justifies the inference that such was the parties' intent. In such a case the use of the security by the landlord for his own purposes would amount to a conversion. If the lease, however, contains no such provisions, the relation existing will be deemed to be that of debtor and creditor. For instance, where the lease provides that the security has been deposited with the landlord for the faithful performance of the lease by the tenant and is to be returned to the tenant upon expiration of the term, the landlord will be deemed to have the right to use the money, and will not be guilty of conversion in so doing.<sup>28</sup>

Although this statement of the law was cited with approval by the First Department of the Appellate Division,<sup>29</sup> confusion resulted

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the tenant was given the opportunity to substitute other "suitable security" for his deposit. If he met his obligations, the landlord would apply the security to the last six months' rent. The court, applying New York law, ruled that this agreement merely created a debtor-creditor relationship. *Id.* at 938.

27. 146 Misc. 215, 260 N.Y.S. 881 (Sup. Ct. 1932).

28. *Id.* at 216, 260 N.Y.S. at 882.

29. *Levinson v. Shapiro*, 238 App. Div. 158, 263 N.Y.S. 585 (1st Dep't), *aff'd*, 263 N.Y. 591, 189 N.E. 713 (1933). Here the tenant deposited a sum of money as security for the faithful performance of a two-year lease; when he defaulted on his payments, the landlord sued. Asserting that the relationship between them was fiduciary in nature, the tenant counterclaimed for conversion of his security. While proclaiming that no rigid rule could be formulated, the court held that the agreement between the parties would control and that *Mendelson* stated the correct rule: "No hard and fast rule can be laid down to govern the respective rights and liabilities of

from the Fourth Department's decision in *In re Atlas*,<sup>30</sup> and it was largely through that case that the "trust fund doctrine" eventually gained legislative<sup>31</sup> and judicial<sup>32</sup> acceptance. In *Atlas* the landlord leased a theater to the tenant and required him to deposit five thousand dollars to be held in escrow as security for performance of the lease.<sup>33</sup> In fact, the landlord placed the deposit in a personal bank account and depleted the tenant's security. When the tenant failed to pay his monthly rent, the landlord instituted eviction proceedings. The tenant, citing the depletion of his security by the landlord, counterclaimed for conversion. The court ruled favorably on the counterclaim holding that the sum deposited by the lessee did not become the property of the lessor.<sup>34</sup> The money was entrusted to the landlord as security against the tenant's default in the performance of the lease, and unless applied to such defaults the security was to be held by the lessor "intact on deposit with some bank."<sup>35</sup>

The decision in *Atlas* received nominal judicial acceptance. Some lower courts, prodded by the inherent inequities in the landlord-tenant relationship, soon began to follow this interpretation.<sup>36</sup> How-

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a landlord and tenant with respect to the use or non-use of moneys paid over to the landlord as security. The parties can stipulate that the deposit be held intact and unused as a fund to be set apart; or they may fail to do so. Here, they have not so contracted and the circumstances of the transaction as well as the language of the lease itself do not indicate an intention that this small sum was required to be kept in a separate fund. . . . The nub of the matter is that if the parties had desired to restrict the landlord in the use of the moneys, they would have so provided by appropriate language." *Id.* at 160, 263 N.Y.S. at 587-88.

30. 217 App. Div. 38, 216 N.Y.S. 490 (4th Dep't 1926).

31. N.Y. GEN. OBLIG. LAW § 7-103 (McKinney Supp. 1974).

32. See, e.g., *Sommers v. Timely Toys, Inc.*, 110 F. Supp. 844 (E.D.N.Y. 1953); *Sadow v. Poskin Realty Corp.*, 63 Misc. 2d 499, 312 N.Y.S.2d 901 (Sup. Ct. 1970); *Land v. Gladol*, 18 Misc. 2d 103, 187 N.Y.S.2d 216 (Sup. Ct. 1959).

33. 217 App. Div. at 39-40, 216 N.Y.S. at 492.

34. *Id.* at 41-42, 216 N.Y.S. at 494.

35. *Id.*

36. In *Alumor Garage, Inc. v. Stivers, Inc.*, 128 Misc. 400, 218 N.Y.S. 683 (Mun. Ct. 1926), the court held that the proper interpretation of the lease agreement was that quoted in *Atlas*. *Id.* at 402, 218 N.Y.S. at 685. The court further held that even though the landlord had invested the

ever, most courts were reluctant to impose a fiduciary relationship upon the parties, finding *Atlas* to be limited to its particular facts.<sup>37</sup> Although the presence of an escrow clause possibly distinguishes *Atlas*, it is difficult to comprehend how a decision on that set of facts detracts from the general rule established by *Mendelson*.<sup>38</sup>

Some decisions following *Atlas* are not so easily reconcilable.<sup>39</sup> These cases construed the landlord-tenant relationship to be one of

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money in state bonds, no conversion occurred since this constituted a valid investment for trust funds under New York law. There was no duty on behalf of the landlord to keep money on deposit in a bank since there was no escrow provision as in *Atlas*. *Id.* at 402-03, 218 N.Y.S. at 686. In *Euclid Holding Co. v. Kermacoe Realty Co.*, 131 Misc. 466, 227 N.Y.S. 103 (Mun. Ct. 1928), the argument that the security created only an indemnity contract and not a fiduciary obligation was advanced and rejected as inappropriate. The court regarded *Atlas* and *Alumor Garage* as controlling. *Id.* at 468, 470, 227 N.Y.S. at 105, 108. In *Frost v. Paulster Realty Corp.*, 138 Misc. 597, 247 N.Y.S. 808 (Westchester County Ct. 1930), the tenant agreed to pay the security by various checks. One check was then endorsed by the landlord over to his attorney. A second check was given by the landlord to the agent who, in turn, endorsed it back to the tenant. Upon the tenant's suit for breach of trust, the court, finding that the conduct of the parties created a debtor-creditor relationship, said that if the division of the security had not occurred with the knowledge and acquiescence of the tenant, the deposit would be treated as a trust fund. *Id.* at 599, 247 N.Y.S. at 810. In an earlier case, the New York Supreme Court had occasion to resolve a similar question, and its holding seems to have foreshadowed the *Atlas* decision. In *Degnario v. Sire*, 34 Misc. 163, 68 N.Y.S. 789 (Sup. Ct. 1901), a tenant sued for the alleged conversion of his security by his landlord. The court held that money so deposited was money deposited for a special purpose, and that title did not pass to the lessor. The landlord was required to hold the security intact and return it to his lessee upon compliance with the lease agreement, and failure to do so was a conversion. *Id.* at 165, 68 N.Y.S. at 790.

37. See, e.g., *Levinson v. Shapiro*, 238 App. Div. 158, 160, 263 N.Y.S. 585, 588 (1st Dep't 1933); *Goodman v. Schached*, 144 Misc. 905, 910-11, 260 N.Y.S. 883, 888-89 (Nassau County Ct. 1932); *Houston Varick Oper. Corp. v. 206-208 Varick St. Corp.*, 142 Misc. 863, 865, 255 N.Y.S. 60, 62 (Mun. Ct. 1932).

38. 146 Misc. at 216, 260 N.Y.S. at 882.

39. See, e.g., *Euclid Holding Co. v. Kermacoe Realty Co.*, 131 Misc. 466, 227 N.Y.S. 103 (Mun. Ct. 1928); *Alumor Garage, Inc. v. Stivers, Inc.*, 128 Misc. 400, 218 N.Y.S. 618 (Mun. Ct. 1926).

trust absent an "escrow" provision. Implicit in their reasoning was the idea that if the relationship was merely that of debtor-creditor, the tenant could insist only upon a personal obligation of the landlord. This obligation, in turn, would be of little value in the event of the landlord's insolvency.<sup>40</sup> If the relationship were one of trust, however, the deposit becomes a trust fund which remains the property of the lessee. This enables the tenant to repossess the deposit in spite of the insolvency of the landlord, if the money is on hand. Fortunately, the legislature did not permit the confusion within the judicial system to fester.

### III. Legislative Modifications of the Landlord's Duties

The New York Legislature has resolved much of the confusion and discord perpetuated by the courts.<sup>41</sup> The relationship between land-

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40. *People v. Horowitz*, 309 N.Y. 426, 131 N.E.2d 715 (1956).

41. N.Y. GEN. OBLIG. LAW § 7-103 (McKinney Supp. 1974) reads as follows: "1. Whenever money shall be deposited or advanced on a contract or license agreement for the use or rental of real property as security for performance of the contract or agreement or to be applied to payments upon such contract or agreement when due, such money, with interest accruing thereon, if any, until repaid or so applied, shall continue to be the money of the person making such deposit or advance and shall be held in trust by the person with whom such deposit or advance shall be made and shall not be mingled with the personal moneys or become an asset of the person receiving the same, but may be disposed of as provided in section 7-105 of this chapter. 2. Whenever the person receiving money so deposited or advanced shall deposit such money in a banking organization, such person shall thereupon notify in writing each of the persons making such security deposit or advance, giving the name and address of the banking organization in which the deposit of security money is made, and the amount of such deposit. If the person depositing such security money in a banking organization shall deposit same in an interest bearing account, he shall be entitled to receive, as administration expenses, a sum equivalent to one per cent per annum upon the security money so deposited, which shall be in lieu of all other administrative and custodial expenses. The balance of the interest paid by the banking organization shall be the money of the person making the deposit or advance and shall either be held in trust by the person with whom such deposit or advance shall be made, until repaid or applied for the use or rental of the leased premises, or annually paid to the person making the deposit of security money. 2-a. Whenever the money so deposited or advanced is for the rental of property containing six or more family dwelling units, the person receiving such



lord and tenant can no longer be construed as that of debtor and creditor:<sup>42</sup> rather it is now fiduciary in nature,<sup>43</sup> and the deposit itself constitutes a trust fund which the landlord, as trustee, must segregate and keep intact.<sup>44</sup>

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money shall, subject to the provisions of this section, deposit it in an interest bearing account in a banking organization which account shall earn interest at a rate which shall be the prevailing rate earned by other such deposits made with banking organizations in such area. 2-b. In the event that a lease terminates other than at a time that a banking organization in such area regularly pays interest, the person depositing such security money shall pay over to his tenant such interest as he is able to collect at the date of such lease termination. 3. Any provision of such contract or agreement whereby a person who so deposits or advances money waives any provision of this section is absolutely void. 4. The term "real property" as used in this section is co-extensive in meaning with lands, tenements and hereditaments." With respect to the banking of such deposits by landlords, N.Y. BANKING LAW § 237(4) (McKinney Supp. 1974) provides: "Notwithstanding any inconsistent provision of law, a savings bank may accept deposits of moneys paid under and as security for the performance of any lease or leases, or to be applied to payments under such lease or leases when due, although the person depositing such moneys is held accountable therefor as a trustee of trust funds. Moneys received from or held for persons under more than one lease may be deposited in one or more accounts. Notwithstanding any inconsistent provision of law, the word 'person' as used in this subdivision four shall include an individual, municipal corporation, partnership, corporation, association or any other organization operated for profit."

42. N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney Supp. 1974).

43. *Id.* See also *Sommers v. Timely Toys, Inc.*, 110 F. Supp. 844 (E.D.N.Y. 1953); *People v. Horowitz*, 309 N.Y. 426, 131 N.E.2d 715 (1956); *In re Perfection Technical Servs. Press, Inc.*, 22 App. Div. 2d 352, 256 N.Y.S.2d 166 (2d Dep't), *aff'd*, 18 N.Y.2d 644, 819 N.E.2d 424, 273 N.Y.S.2d 714 (1965).

44. N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney Supp. 1974); *Sommers v. Timely Toys, Inc.*, 110 F. Supp. 844 (E.D.N.Y. 1953); *Sadow v. Poskin Realty Corp.*, 63 Misc. 2d 499, 312 N.Y.S.2d 901 (Sup. Ct. 1970); *Land v. Gladol*, 18 Misc. 2d 103, 187 N.Y.S.2d 216 (Sup. Ct. 1959). The statute, however, cannot be construed to protect security that is not for performance of the lease. In *Mercantile Exch. Leasing Corp. v. Astor-Broadway Holding Corp.*, 4 Misc. 2d 135, 159 N.Y.S.2d 1003 (Sup. Ct. 1956), a ten-year lease was executed on November 15, 1955, but would not commence until April 1, 1956. In the interim the tenant was to take preparatory steps toward using the space and was to deposit \$25,000 with the

Section 7-103 of the New York General Obligations Law<sup>45</sup> operates to protect a tenant against misappropriations of his security by his landlord.<sup>46</sup> As stated by the New York Court of Appeals:

In enacting section 233 [now section 7-103], the Legislature was attempting to prevent the depletion of funds deposited with the lessor. The method used was to transform the usual debtor-creditor relationship between the lessor and the lessee into one of trust relationship, by operation of law.<sup>47</sup>

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landlord. The security would constitute liquidated damages in the event of a breach. When the lessee cancelled and sued to recover his deposit, the court held the statute inapplicable. Since the security related to the right of the plaintiff to become a tenant and the performance of preliminary obligations in connection with this right, the statute did not apply.

45. N.Y. GEN. OBLIG. LAW § 7-103 (McKinney Supp. 1974).

46. *Mallory Associates v. Barving Realty Co.*, 300 N.Y. 297, 90 N.E.2d 468 (1949); *accord*, *In re Pal-Playwell, Inc.*, 334 F.2d 389 (2d Cir. 1964); *People v. Horowitz*, 309 N.Y. 426, 131 N.E.2d 715 (1956). *See also* *Wald v. Gold*, 1 Misc. 2d 756, 147 N.Y.S.2d 250 (Sup. Ct. 1955), where the court held that even though the deposit was made by a third party for the tenant, the security was to be treated as if made by the tenant himself.

47. *Mallory Associates v. Barving Realty Co.*, 300 N.Y. 297, 301-02, 90 N.E.2d 468, 471 (1949). As originally enacted, the statute applied only to transfers of designated real estate, and did not protect licensees. In *People v. Horowitz*, 309 N.Y. 426, 131 N.E.2d 715 (1956) a license was granted for a concession in defendant's theaters, defendant depositing approximately five thousand dollars to guarantee performance of the lease. The theaters closed after three months, and the defendant refused to repay the security. The court of appeals found the statute inapplicable: "There may be no essential reason on account of which the Legislature might not similarly have protected a deposit of security by a licensee. Section 233 of the Real Property Law [now N.Y. GEN. OBLIG. LAW § 7-103(1)], however, creates this fiduciary status only in the case of contracts 'for the use or rental of real property.' That expression is well understood, and imports the ordinary landlord and tenant relationship involving transfer of possession of designated space in real estate . . . . This kind of concession, regardless of whether the contract describes the parties as landlord and tenant, does not create that relationship in law in the absence of a demise of space in a building." *Id.* at 428-29, 131 N.E.2d at 716; *accord*, *Planetary Recreations, Inc. v. Kerns*, 184 Misc. 340, 54 N.Y.S.2d 418 (N.Y. City Ct. 1945), where plaintiff was granted a concession in defendant's restaurant upon the payment of \$6000. In plaintiff's suit for conversion the court held the statute inapplicable because the agreement did not yield possession of any particular part of the property.

The New York Court of Appeals has also held that section 7-103 is not limited to deposits made under a contract for the use or rental of real property situated in New York. In *Mallory Associates v. Barving Realty Co.*,<sup>48</sup> landlord and tenant, New York corporations with offices located in New York, executed a lease and deposited the security in New York. The court held the statute applicable even though the premises were located out of the state. The court found no evidence that the legislature intended to limit the statute to deposits for the use of real property situated in New York.<sup>49</sup> Although the court applied the statute in a situation involving non-New York realty, it expressly disclaimed the granting of extraterritorial operation.<sup>50</sup> Section 7-103 does not prevent the existence of a debtor-creditor relationship between a landlord and his tenant. In *Ja-Mo Associates, Inc. v. 56 Fulton St. Garage Corp.*,<sup>51</sup> the parties had executed a lease and attached a rider which provided that the tenant would "loan" the landlord forty thousand dollars. The landlord was to execute a mortgage which would be assigned by the tenant to the landlord as security for the tenant's performance of the lease. After the tenant defaulted on his rental payments, a stipulation was executed which gave the landlord possession of the premises. The tenant then sued to recover his forty thousand dollars deposit. The appellate division held the statute inapplicable, pointing out that the forty thousand dollars was actually given as partial consideration for the lease, and not deposited as security.<sup>52</sup> The court noted:

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48. 300 N.Y. 297, 90 N.E.2d 468 (1949).

49. *Id.* at 302, 90 N.E.2d at 471.

50. *Id.* This section merely governs the rights and liabilities of New York corporations under a contract executed in New York, and in reference to New York subject matter—the security deposit. However, where the landlord was a Florida resident, the realty located in Florida, the lease largely negotiated and performed in Florida, and where the security deposit was maintained in Florida, this section did not apply. The commingling by the landlord, therefore, did not entitle the tenant to a return of his security deposit. *Alachua Inn Corp. v. Cooper*, 66 Misc. 2d 479, 421 N.Y.S.2d 222 (Sup. Ct. 1971).

51. 30 App. Div. 2d 287, 291 N.Y.S.2d 62 (1st Dep't 1968); see *In re Amphitheatre, Inc.*, 405 F.2d 309 (2d Cir. 1968); 800 Union St. Corp. v. Bookben Realty Corp., 278 App. Div. 708, 103 N.Y.S.2d 359, *aff'd*, 302 N.Y. 926, 100 N.E.2d 188 (1951).

52. 30 App. Div. 2d at 290, 291 N.Y.S.2d at 65-66.

Although the mortgage securing the tenant's loan was assigned by it to the landlord as security for the performance of the lease, the true nature of the transaction was not thereby converted into one for the deposit of money as security. The assigned mortgage was not cash security which could be commingled by the landlord with his other assets. The mortgage transaction was itself a means of furnishing the landlord with security in lieu of that provided by section 7-103 . . . .<sup>53</sup>

In the absence of a contrary agreement, the landlord, upon receipt of a security deposit, must segregate the fund and keep it intact.<sup>54</sup> He may not commingle the deposit with his own funds or in any way use it for his own benefit.<sup>55</sup> If he does, he may be liable for conversion<sup>56</sup> and forfeit any right to the deposit.<sup>57</sup> The tenant may

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53. *Id.* The court also stated that it would not be bound by labels the parties attached to the payments, and it would examine the true nature of the transaction to determine whether the statute applied. *See Prudential Westchester Corp. v. Tomasino*, 5 App. Div. 2d 489, 172 N.Y.S.2d 652 (1st Dep't 1958); *Bogart Packing Co. v. John-Jordan, Inc.*, 102 N.Y.S.2d 133 (Sup. Ct. 1950); J. RASCH, LANDLORD AND TENANT AND SUMMARY PROCEEDINGS § 400 (2d ed. 1971) [hereinafter cited as RASCH].

54. *See Ferguson v. Vaughn Imported Cars, Inc.*, 9 Misc. 2d 188, 163 N.Y.S.2d 884 (Sup. Ct. 1957), where placing the deposit in the name of another living person was held not to be a holding within the requirements of the section.

55. *Stuarco, Inc. v. Slafbro Realty Corp.*, 30 App. Div. 2d 80, 289 N.Y.S.2d 883 (2d Dep't 1968); *In re Perfection Technical Servs. Press, Inc.*, 22 App. Div. 2d 352, 256 N.Y.S.2d 166 (2d Dep't 1965); *In re Izrue Corp.*, 58 Misc. 2d 343, 295 N.Y.S.2d 204 (Sup. Ct. 1968); RASCH § 401.

56. *In re Tru-Seal Aluminum Prods. Corp.*, 170 F. Supp. 902 (E.D.N.Y. 1959), *aff'd*, 278 F.2d 143 (2d Cir. 1960); *In re Izrue Corp.*, 58 Misc. 2d 343, 295 N.Y.S.2d 204 (Sup. Ct. 1968); *2300 Concourse Realty Corp. v. Klug*, 201 Misc. 179, 111 N.Y.S.2d 168 (Mun. Ct. 1952); *cf. Tow v. Maidman*, 56 Misc. 2d 468, 288 N.Y.S.2d 837 (Sup. Ct. 1968), where the tenant leased property for which he deposited five thousand dollars as security. The security was to be returned after termination of the lease, and the landlord was granted the right, in the event of sale of the property, to transfer the security to the vendee. At all relevant times, the security was maintained in a separate account. When the property was sold by the landlord, a closing adjustment apportioned as a credit to the vendee included tenant's security. The tenant sought to recover his deposit on the theory that the extension of credit for the security constituted a conversion. The court held that although there was a momentary use of the security as a credit for the vendor's benefit, no conversion would lie since there was no depletion of the deposit. *Id.* at 470, 288 N.Y.S.2d at 839.

then sue for conversion or counterclaim for the deposit in any action by the landlord for rent.<sup>58</sup> Finally, any agreement purporting to waive any provision of section 7-103 is "absolutely void."<sup>59</sup>

A number of cases have qualified the proscription against commingling by landlords.<sup>60</sup> In an action by a tenant to recover his deposit, it was held that the tenant was not entitled to recover his security simply because the landlord temporarily placed the deposit in a bank account containing his own funds.<sup>61</sup> The landlord had segregated his deposit prior to commencement of the action and the tenant had remained in possession of the premises.<sup>62</sup>

If the landlord can eschew liability by simply segregating the deposit before the conclusion of the trial,<sup>63</sup> the tenant becomes a double loser. Not only has he failed to reacquire his security, but he has also incurred the expense of bringing the suit. The landlord's

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57. *Cherno v. Engine Air Serv., Inc.*, 330 F.2d 191 (2d Cir. 1964); *In re Radiant Sys., Inc.*, 253 F. Supp. 776 (E.D.N.Y. 1965); *In re DeGregorio*, 219 F. Supp. 783 (S.D.N.Y. 1963).

58. *Mercantile Exch. Leasing Corp. v. Astor-Broadway Holding Corp.*, 3 App. Div. 2d 883, 161 N.Y.S.2d 677 (1st Dep't), *aff'd*, 4 N.Y.2d 910, 151 N.E.2d 92, 174 N.Y.S.2d 661 (1958); RASCH § 401.

59. N.Y. GEN. OBLIG. LAW § 7-103(3) (McKinney Supp. 1974); *Ja-Mo Associates, Inc. v. 56 Fulton St. Garage Corp.*, 30 App. Div. 2d 287, 291 N.Y.S.2d 63 (1st Dep't 1968); *In re Izrue Corp.*, 58 Misc. 2d 343, 295 N.Y.S.2d 204 (Sup. Ct. 1968); 1970 OP. ATT'Y GEN. 18.

60. *160 Realty Corp. v. 162 Realty Corp.*, 113 N.Y.S.2d 618 (Sup. Ct.), *aff'd*, 280 App. Div. 762, 113 N.Y.S.2d 678 (1st Dep't 1952) (mem.) (where the landlord commingled the security with his own funds, but prior to the commencement of the action had segregated the deposit. The tenant was held not entitled to a return of his security); *Bridge Hardware Co. v. Mayer*, 131 N.Y.S.2d 823 (Sup. Ct. 1954) (where the landlord neglected to place the security in a separate fund, but the evidence disclosed the deposit was intact and segregated in a special account prior to the conclusion of trial. The court felt that *160 Realty Corp.*, *supra*, was indistinguishable); *accord*, 19 North Village Realty Corp. v. Kominos, 3 Misc. 2d 768, 155 N.Y.S.2d 318 (Sup. Ct. 1956), *aff'd*, 3 App. Div. 2d 754, 160 N.Y.S.2d 825 (2d Dep't 1957).

61. *160 Realty Corp. v. 162 Realty Corp.*, 113 N.Y.S. 2d 618 (Sup. Ct. 1952).

62. *Id.* at 619. Generally, the lease must remain in force as well. See note 60 *supra*.

63. See *Bridge Hardware Co. v. Mayer*, 131 N.Y.S.2d 823 (Sup. Ct. 1954).

statutory duty is phrased in absolute terms: security deposit money he receives as trustee "shall not be mingled" with any of his personal moneys.<sup>64</sup> Nowhere does it state, or can it be implied, that such commingling can occur occasionally.<sup>65</sup> The statutory mandate is clear, and continuing judicial refusal to follow the dictates of the law will lead to the unjust expenditures of tenants' time, effort, and money.

The landlord's duty to maintain the deposit intact and the tenant's obligation to pay rent have been held to be mutually independent.<sup>66</sup> Therefore, the conversion of the security by the landlord will not constitute a valid defense to a landlord's claim for rent.<sup>67</sup> The purpose of section 7-103 is to accord the tenant greater protection with respect to his security than he enjoyed at common law.<sup>68</sup> If the respective duties of the tenant and the landlord are to remain mutually independent, the tenant faces two alternatives when a landlord converts his security: (a) he may choose to cease his rental payments, in which case the landlord may institute a summary proceeding to dispossess,<sup>69</sup> or (b) if the tenant chooses to continue his rent payments and sues to recover his deposit, he is faced with the prospect of investing large amounts of time and money to recover his security.<sup>70</sup> For the knowledgeable landlord, the entire pro-

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64. N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney Supp. 1974).

65. *Id.*

66. *Turquoise Realty Corp. v. Burke*, 168 Misc. 670, 6 N.Y.S.2d 125 (Mun. Ct. 1938).

67. *Id.* It has also been held that a landlord, having converted the security deposit, may not set off his claims for unpaid rent where an assignee for the benefit of creditors seeks to recover the deposit. *In re Perfection Technical Servs. Press, Inc.*, 22 App. Div. 2d 352, 256 N.Y.S.2d 166 (2d Dep't), *aff'd*, 18 N.Y.2d 230, 273 N.Y.S.2d 71 (1965); *In re John Holst Co.*, 213 N.Y.S.2d 952 (Sup. Ct. 1961). *Contra*, *Pollack v. Springer*, 195 Misc. 523, 91 N.Y.S.2d 847 (N.Y. City Ct. 1949), where a landlord was entitled to set off his judgment for unpaid rent in a suit by the tenant to recover his security deposit.

68. *See* note 47 *supra* and accompanying text.

69. While the tenant may counterclaim for the conversion of his security, the final result is that not only will he have been evicted, but the landlord will have been able to use the security money profitably in the interim.

70. A common theme voiced by several New York City Tenants' Asso-

cedure thus becomes one of risks and basic economics. If the statute is to effectively protect tenants, the tenant should be entitled to use the conversion of his security as a set-off to a landlord's claim for rent.

The sanctions imposed by this section of the statute are still inadequate. Under section 7-103 the tenant is free to go into court and seek redress for the landlord's breach.<sup>71</sup> This procedure, however, is time-consuming and costly, with tenants often unable to pursue their statutory remedy because the cost of litigating would be prohibitive, perhaps even exceeding the amount of recovery.<sup>72</sup> The solution may simply require a more stringent civil remedy, such as an award of punitive or treble damages. If this fails, a criminal penalty could be appropriate.<sup>73</sup>

#### IV. The Fate of a Security Deposit Upon a Tenant's Breach

Upon a tenant's breach of some or all of the covenants of a lease,

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ciations during a series of interviews in August, 1974, was the reluctance of many members to litigate in order to regain security that was equal to the sum of one month's rent.

71. *Mercantile Exch. Leasing Corp. v. Astor-Broadway Holding Corp.*, 3 App. Div. 2d 883, 161 N.Y.S.2d 677 (1st Dep't), *aff'd*, 4 N.Y.2d 910, 151 N.E.2d 92, 174 N.Y.S.2d 661 (1958); RASCH § 401.

72. It has been stated that "the usual way to force a citizen to observe higher standards of conduct is by the use of criminal sanctions." Quinn & Phillips, *The Law of Landlord-Tenant: A Critical Evaluation of the Past with Guidelines for the Future*, 38 FORDHAM L. REV. 225, 239 (1970). In *People v. Klinger*, 164 Misc. 530, 300 N.Y.S. 408 (Magis. Ct. 1937), the landlord was held criminally liable for the misappropriation of the tenant's security deposit. The court felt, however, that criminal liability was dictated by sections 1290 and 1302 of the Penal Law, not by section 233 of the Real Property Law (now N.Y. GEN. OBLIG. LAW § 7-103 (McKinney Supp. 1974)). *Cf. People v. Horowitz*, 309 N.Y. 426, 131 N.E.2d 715 (1956), where the defendant was also prosecuted for his refusal to return the tenant's security. The court never decided whether such conduct was criminal since section 233 of the Real Property Law did not, at that time, apply to license agreements.

73. Section 7-105 provides criminal sanctions for failure to adhere to its dictates. The impetus for the statute was the legislative desire to provide greater protection to tenants. To ensure strict compliance by landlords, a remedy as potent as that provided by section 7-105 should be made available to enforce violations of section 7-103.

the fate of a security deposit is governed by common law.<sup>74</sup> The deposit is either treated as a penalty, for which the sum acts as payment of a portion or all of the landlord's actual damages, or as liquidated damages, in which case the sum is treated as the equivalent of the landlord's prospective loss.<sup>75</sup> Whether a security deposit is to be construed as a penalty or as liquidated damages remains a fundamental contract question. The literal language of the lease is not determinative.<sup>76</sup>

Courts will generally construe a security deposit as a penalty where damages flowing from the breach are readily ascertainable at the signing of the lease, or where the amount fixed by the lease is plainly disproportionate to the actual injury.<sup>77</sup> Where actual damages exceed the sum of the deposit, the landlord may elect to keep the deposit and hold the tenant liable for the difference.<sup>78</sup> Where actual damages are less than the sum of the deposit, the tenant is entitled to a refund of the difference.<sup>79</sup>

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74. See RASCH § 379.

75. *Id.*

76. The agreement must be construed according to the contract's terms, the parties' intent, and the surrounding circumstances. *Feinsot v. Burstein*, 78 Misc. 259, 138 N.Y.S. 185 (Sup. Ct. 1912), *aff'd*, 161 App. Div. 651, 146 N.Y.S. 939 (1st Dep't), *aff'd*, 213 N.Y. 703, 108 N.E. 1093 (1914). Construction leases also apply this test. *Mosler Safe Co. v. Maiden Lane Safe Deposit Co.*, 199 N.Y. 479, 93 N.E. 81 (1910); *Ward v. Hudson River Bldg. Co.*, 125 N.Y. 230, 26 N.E. 256 (1891).

77. The lease must be interpreted as of its date and not as of the breach in construing the intended application of the security deposit. *Seidlitz v. Auerbach*, 230 N.Y. 167, 129 N.E. 461 (1920). The distinction here is that the precise sum was not of the essence of the agreement, but rather in the nature of security for performance. See *Ward v. Hudson River Bldg. Co.*, 125 N.Y. 230, 26 N.E. 256 (1891); *Mann v. Taylor*, 258 App. Div. 461, 17 N.Y.S.2d 121 (2d Dep't 1940); *Realworth Properties, Inc. v. Bachler*, 33 Misc. 2d 39, 223 N.Y.S.2d 910 (Sup. Ct. 1962).

78. See *Caesar v. Rubinson*, 174 N.Y. 492, 67 N.E. 58 (1903).

79. The principle was first applied in *Seidlitz v. Auerbach*, 230 N.Y. 167, 129 N.E. 461 (1920). The landlord is not confined to the deposit as a remedy, but if he does resort to it, he will be entitled to no more of it than will make him whole; that is, to indemnify him for the actual damages he may have sustained by reason of the breach. See also *Peinson v. Lloyds First Mortgage Co.*, 260 N.Y. 214, 183 N.E. 368 (1932); *Prudential Westchester Corp. v. Tomasino*, 5 App. Div. 2d 489, 172 N.Y.S.2d 652 (1st Dep't



For the deposit to be construed as liquidated damages, the parties must have shown an attempt to apportion the amount of the deposit to the probable loss that would flow from the breach.<sup>80</sup> Thus, if it appears that the anticipated loss from the tenant's default is uncertain and incapable of exact measurement, or if the deposit is reasonably proportionate to the actual injury flowing from the breach, the parties' stipulation of the deposit as "liquidated damages" in the lease will be honored.<sup>81</sup> The parties' agreement must not be "but a cloak of language to attempt to hide a sum which is out of proportion to, and differs greatly from, the actual damages which would in the ordinary course be suffered."<sup>82</sup> In cases that might reasonably be decided either way, the tendency of courts is to interpret the deposit as a general security measure to compensate for actual damages and therefore to treat it as a penalty.<sup>83</sup>

The above tests are applied where a lease is comprised of several covenants of varying degrees of importance to the whole. In *Seidlitz*

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1958), *aff'd*, 6 N.Y.2d 824, 159 N.E.2d 699, 188 N.Y.S.2d 214 (1959); *Folger v. Raczek*, 167 App. Div. 167, 152 N.Y.S. 1041 (2d Dep't 1915). But the tenant must await the original expiration date of the lease before claiming a return of the deposit, since only then can all of the landlord's damages be ascertained. See *Milton M. Senz, Inc. v. Hammer*, 265 N.Y. 344, 193 N.E. 168 (1934); *Henochstein v. Nachman*, 218 App. Div. 673, 219 N.Y.S. 199 (1st Dep't 1926).

80. "The parties must not lose sight of the principle of compensation," urged Judge Andrews in *Seidlitz v. Auerbach*, 230 N.Y. 167, 174, 129 N.E. 461, 463 (1920). Here, actual damages were found plainly disproportionate to the damages fixed as "liquidated" in the lease.

81. *J. & H. Garage, Inc. v. H. Flow Corp.*, 225 App. Div. 65, 232 N.Y.S. 242 (1st Dep't 1928), *aff'd*, 251 N.Y. 553, 168 N.E. 424 (1929). The court held that the deposit, fixed as "liquidated damages," was not shown to differ markedly from the damages "suffered in the ordinary course," so as to require the court to disregard the express stipulation of the parties. See *Realworth Properties, Inc. v. Bachler*, 33 Misc. 2d 39, 223 N.Y.S.2d 910 (Sup. Ct. 1962), in which the landlord's actual loss was held to have been incapable of computation at the time of the parties' agreement. Thus, the stipulation of the deposit as "liquidated damages" had neither been unreasonable nor unconscionable.

82. *J. & H. Garage, Inc. v. H. Flow Corp.*, 225 App. Div. 65, 67, 232 N.Y.S. 242; 244 (1st Dep't 1928).

83. *City of New York v. Brooklyn & Manhattan Ferry Co.*, 238 N.Y. 52, 143 N.E. 788 (1924).

*v. Auerbach*<sup>84</sup> the tenant's deposit of \$7,500 was paid "[a]s security for the faithful performance by the tenant of all the covenants and agreements herein contained and to indemnify the landlord against loss by reason of any such default . . . ."<sup>85</sup> The covenants included such minor duties as keeping the sidewalk free from snow, and payment of premiums for an insurance policy. The tenant, who breached and was evicted for his failure to pay one month's rent, brought the action to recover the value of his security deposit less actual damages. Rejecting the language of the lease,<sup>86</sup> the court construed the deposit as a penalty. Thus, plaintiff was awarded the remainder of the deposit.<sup>87</sup> The test is whether the security is out of proportion to the ascertainable damages flowing from the material breach in the ordinary course of events.<sup>88</sup>

In *J. & H. Garage, Inc. v. H. Flow Corp.*,<sup>89</sup> the lease itself provided that the security deposit was to be treated as liquidated damages only if the premises were surrendered or if the tenant was dispossessed prior to the lease's expiration. The tenant was subsequently evicted for nonpayment of rent. On the facts, the court found that a reasonable estimate of the actual damages did not vary disproport-

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84. 230 N.Y. 167, 129 N.E. 461 (1920).

85. *Id.* at 170, 129 N.E. at 462.

86. The lease included the following provision: "[A]s the damages which the landlord would sustain in the event of a default by the tenant hereunder would not be susceptible of ascertainment, it is hereby covenanted and agreed between the landlord and tenant that in the event of any such default the damages sustained by the said landlord be and they are hereby fixed and liquidated at the amount of seven thousand five hundred dollars so deposited as aforesaid, without any deduction or offset whatever." *Id.* at 170-71, 129 N.E. at 462.

87. The court noted: "It is impossible to believe that the lessor and the lessees intended that the sum of \$7500 should be treated alike as liquidated damages for the breach of a covenant involving the payment of many thousand dollars of rent and of a covenant involving the payment of an insurance premium of \$17." *Id.* at 174, 129 N.E. at 463.

88. The leading case is *Hackenheimer v. Kurtzmann*, 235 N.Y. 57, 138 N.E. 735 (1923), in which the court held that it was the parties' clear intention that the deposit be security against an intentional violation of a promise made by defendant not to injure the company name by private use. The plaintiff had bought defendant's majority share of the company in an agreement that contained many lesser covenants.

89. 225 App. Div. 65, 232 N.Y.S. 242 (1st Dep't 1928).

tionately from the ten thousand dollar deposit. The court thus construed the deposit according to its literal language as liquidated damages, and accorded plaintiff ten thousand dollars as full recovery for its loss.<sup>90</sup>

Not all money deposited by a tenant is intended as security to guarantee performance of the lease. Where money is deposited for a different purpose, such as prepayment of rent, the fate of the sum upon a breach is apparently a matter of common law.<sup>91</sup> Confusion in this area has resulted from an ambiguity in section 7-103(1). Because the statute limits its protection to money deposited as "security,"<sup>92</sup> there are cases holding that a landlord does not become a trustee of the money so deposited if he received it as a prepayment of rent.<sup>93</sup> With this arrangement, he may avoid becoming a trustee

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90. The appellate division noted that the total rent was \$19,000 annually, that vacating the premises would mean several months loss of rent in addition to the cost for repairs. The court found that the tenants' deposit was a reasonable ascertainment of actual damages. *Id.* at 67, 232 N.Y.S. at 244-45; *cf.* *Lenco, Inc. v. Hirschfeld*, 247 N.Y. 44, 159 N.E. 718 (1928). Here the lease provided that a tenant's deposit be retained as liquidated damages in the event of a breach of any covenant. With twenty years remaining on it, the lease also stipulated that the tenant would remain liable for rent losses suffered by the landlord for the duration. The court construed the deposit as a penalty. Upon evidence that the landlord was attempting in good faith to relet the premises, the court held that plaintiff's action to recover the security was premature. Recovery had to await the liquidation of the landlord's actual loss. *Id.* at 50, 159 N.E. at 720. Logically, *Lenco* would have been decided differently had the parties agreed to accept the deposit as liquidated damages specifically for a material breach, such as the loss of future rents ensuing in the ordinary course from an eviction.

91. Courts will attempt to ascertain the intention of the parties by examining the lease in light of all the circumstances relevant to its formation. *Prudential Westchester Corp. v. Tomasino*, 5 App. Div. 2d 489, 172 N.Y.S.2d 652 (1st Dep't 1958); *aff'd*, 6 N.Y.2d 824, 159 N.E.2d 699, 188 N.Y.S.2d 214 (1959).

92. See note 41 *supra*.

93. *In re Dilbert's Leasing & Dev. Corp.*, 345 F.2d 172 (2d Cir. 1965); *34 W. 34th St. Corp. v. Nehama Realty Corp.*, 7 Misc. 2d 532, 153 N.Y.S.2d 427 (Sup. Ct. 1956). In the latter case the court said: "There is no doubt that a lease may provide for payment of the rent in any manner or at any time that the parties elect. Section 233 of the Real Property Law [now N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney Supp. 1974)] provides that

of the tenant's deposit by simply choosing to describe the money received as prepaid rent instead of security, in which case the landlord merely occupies the position of debtor.<sup>94</sup> The distinction is especially significant when a landlord becomes bankrupt and has already commingled a tenant's prepayment with his own personal funds. In a suit brought by a tenant to recover the entire deposit from the bankrupt's assignee, a federal court<sup>95</sup> held that the bankrupt was a mere debtor as to that portion of the tenant's deposit which was stipulated in the lease as the prepayment of rent.<sup>96</sup> Therefore, the landlord was not guilty of conversion, and the tenant was not entitled to priority over the landlord's general creditors.<sup>97</sup> In a more recent decision,<sup>98</sup> however, a lower New York court moved to curb the inequities that result from such a literal interpretation of the statute. The court held a landlord liable for commingling a tenant's prepayment of rent with his personal funds.<sup>99</sup> It said:

An examination of the words of the statute makes it clear that it is applicable whether the deposit was made "as security for performance of the contract or agreement or to be applied to payments upon such contract or agreement when due." Thus whether called security or prepaid rent, the statute is applicable to these deposits.<sup>100</sup>

Consistent with its liberal interpretation of the statute, the court disregarded the earlier cases which held section 7-103(1) inapplicable on substantially similar facts.<sup>101</sup>

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"when money is deposited as security or to be applied to payments when due, such money is to be held in trust by the person receiving it. According to the provisions of this lease, the amount in question is neither security nor to be applied to payments when due. As long as the lease is the contract between the parties there can be no conversion." 7 Misc. 2d at 533, 153 N.Y.S.2d at 428.

94. See note 93 *supra*.

95. *In re Dilbert's Leasing & Dev. Corp.*, 345 F.2d 172 (2d Cir. 1965).

96. *Id.* at 173.

97. *Id.* The court held that the landlord's commingling of the prepaid rent with his personal funds, followed by his bankruptcy, relegated the tenant to the status of creditor.

98. *Purfield v. Kathrane*, 73 Misc. 2d 194, 341 N.Y.S.2d 376 (Civ. Ct. 1973).

99. *Id.* at 200, 341 N.Y.S.2d at 382.

100. *Id.* at 199, 341 N.Y.S.2d at 382 (citation omitted).

101. The court noted that the prepayment was specified as "security"

To place continued reliance upon the reasoning of earlier cases would violate the spirit of the statute. Section 7-103 was enacted to eliminate basic inequities that existed between landlord and tenant at common law.<sup>102</sup> While the statute speaks only of money deposited as "security," this term should be liberally construed to encompass money that is deposited with the landlord as prepayment of rent.

### V. Interest Provisions

A changing and presently controversial area of landlord-tenant law concerns the accrual of interest upon a security deposit. The issue has provoked litigation over sums both large and small.<sup>103</sup>

Prior to statutory regulation, the law was well-settled. In the absence of a specific agreement to pay interest on a deposit, none was chargeable.<sup>104</sup> However, if an agreement exists to pay "interest at the legal rate," the landlord was obligated to pay the statutory interest rate.<sup>105</sup> This has not been changed by statute.<sup>106</sup>

In a recent case,<sup>107</sup> a tenant deposited a sum of money with his landlord as security for the performance of the lease. The landlord invested the deposit in government bonds and collected the interest earned. Instead of retaining this interest in trust for the tenant, the landlord used it for his own benefit. The appellate division, in enunciating the prevailing rule, said:

[T]he plaintiff-tenant is entitled to the interest actually accrued . . . by operation of law, despite the absence of any agreement to pay interest on the

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in the lease. However this fact alone did not control the court's decision. *Id.* at 199-200, 341 N.Y.S.2d at 382.

102. See note 47 *supra* and accompanying text.

103. *New York v. Parkchester Apts. Co.*, 61 Misc. 2d 1020, 307 N.Y.S.2d 741 (Sup. Ct. 1970), where at issue was whether interest could be collected on over one million dollars in security deposits. *Parmaki v. Levine*, 75 Misc. 2d 900, 349 N.Y.S.2d 979 (Civ. Ct. 1973), where the issue concerned recovery of \$22.26 of interest on a security deposit.

104. *Boughton v. Flint*, 74 N.Y. 476 (1878); *In re Cromwell's Estate*, 102 Misc. 503, 169 N.Y.S. 204 (Sup. Ct. 1918); RASCH § 399.

105. *Levy v. Shellsey*, 30 Misc. 789, 63 N.Y.S. 150 (Sup. Ct. 1900); RASCH § 399.

106. N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney Supp. 1974): "[W]ith interest accruing thereon, if any . . ." *Id.* (emphasis added).

107. *Stuarco, Inc. v. Slafbro Realty Corp.*, 30 App. Div. 2d 80, 289 N.Y.S.2d 883 (2d Dep't 1968).

deposit, and this precisely and only because interest was in fact earned thereon. Also, the accrued interest itself earned no interest and the plaintiff is not entitled to interest on interest either or by operation of law or agreement of the parties.<sup>108</sup>

In 1970, statutory law, providing that a landlord, or holder, was under no duty to place the deposit in an interest bearing account, underwent significant revision. The legislature amended section 7-103 of the General Obligations Law to require that all security deposited for a building containing six or more apartment units be placed in interest bearing accounts.<sup>109</sup> The statute already required that this money be held separately from the holder's personal funds.<sup>110</sup>

Reform was spurred by a harsh but logical decision in *New York v. Parkchester Apartments Co.*,<sup>111</sup> which stated<sup>112</sup> that a purchaser of an apartment building acted properly when he transferred one million dollars in security deposits from interest bearing accounts, where they had been placed voluntarily by the former landlord,<sup>113</sup> to non-interest bearing accounts.<sup>114</sup> Since the new landlord was then

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108. *Id.* at 82, 289 N.Y.S.2d at 885-86.

109. N.Y. GEN. OBLIG. LAW § 7-103(2-a) (McKinney Supp. 1974) is ambiguous with regard to which deposits must be placed in interest bearing accounts. However, an informal opinion of the Attorney General is consistent with the message of the Governor that accompanied the amendment. Both interpreted it as requiring only that tenants rent an apartment of whatever size in a building of six or more living units. 1970 OP. ATT'Y GEN. 163; RASCH § 399 n.17.2.

110. N.Y. GEN. OBLIG. LAW § 7-103(2) (McKinney Supp. 1974).

111. 61 Misc. 2d 1020, 307 N.Y.S.2d 741 (Sup. Ct. 1970). Litigation in *Parkchester* was concluded in February, 1970, and the legislature passed section 7-103(2-a) giving tenants greater rights over interest on their security deposits in April of that year.

112. The court held that the suit brought by the Attorney General should be dismissed for lack of standing. *Id.* at 1026, 307 N.Y.S.2d at 748. See text accompanying note 132 *infra*.

113. The defendant was clearly not in violation of section 7-103(1) which then read in part: "Whenever money shall be deposited . . . on a contract . . . for the . . . rental of real property as security for performance of the contract . . . such money, with interest accruing thereon, if any . . . shall be held in trust . . ." N.Y. GEN. OBLIG. LAW § 7-103(1) (McKinney 1964).

114. 61 Misc. 2d at 1026, 307 N.Y.S.2d at 748.

under no statutory obligation to continue the former landlord's policy, annual payments of interest to tenants legally ceased.

Section 7-103 does not apply to a building with less than six dwelling units; an owner of such building is under no obligation to deposit the security in a banking organization.<sup>115</sup> However reasonable this limitation appears on its face, it is an exception that invites abuse. Where a landlord operates suburban cluster housing, for example, or several city brownstones of less than six units, his tenants are apparently left unprotected by the statute. A landlord may own numerous buildings of one to five units each, yet these tenants will be denied statutory protection simply because each building contains less than six units.<sup>116</sup> The requirement that a landlord deposit a security should be based on the number of tenants per landlord rather than units per building.

Under present law, landlords who deposit security in a banking organization must notify tenants in writing of the name and address of the bank, and of the amounts of their deposits.<sup>117</sup> If the landlord deposits the security in an interest bearing account, either voluntarily or as required by law, he is entitled to receive, as an administrative expense, a sum equivalent to "one percent per annum upon the security money so deposited."<sup>118</sup> The balance of the interest is to remain the property of the depositor and shall either continue to be held in trust by the lessor or be paid annually to the person making the deposit.<sup>119</sup> A letter issued by the Office of the Attorney General<sup>120</sup> and at least one court decision<sup>121</sup> interpreted the above language to mean that the tenant has the right to an annual payment of his interest, unless it was agreed in the lease that the interest would

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115. N.Y. GEN. OBLIG. LAW § 7-103(2-a) (McKinney Supp. 1974).

116. *Id.*

117. *Id.* § 7-103(2); 1970 OP. ATT'Y GEN. 17.

118. N.Y. GEN. OBLIG. LAW § 7-103(2) (McKinney Supp. 1974); RASCH § 399. This provision is in lieu of all other administration expenses incurred by the landlord.

119. N.Y. GEN. OBLIG. LAW § 7-103(2) (McKinney Supp. 1974); *see, e.g.*, *Parmaki v. Levine*, 75 Misc. 2d 900, 349 N.Y.S.2d 979 (Civ. Ct. 1973); RASCH § 399.

120. *See Parmaki v. Levine*, 75 Misc. 2d 900, 349 N.Y.S.2d 979, 980 (Civ. Ct. 1973).

121. *Id.* at 901, 349 N.Y.S.2d at 981.

apply as rent. The Attorney General has instructed tenants to demand that interest be paid or used toward rents annually.<sup>122</sup>

The language of section 7-103(2-a) is unclear as to whether it may be applied to security deposits received prior to its passage.<sup>123</sup> A recent New York Supreme Court decision, *People ex. rel Lefkowitz v. Parker*<sup>124</sup> (*Parker II*), held that the law did apply. Defendant-landlord had argued that the legislature intended only that the landlord guarantee interest on deposits acquired after 1970.<sup>125</sup> This reasoning would produce an inequitable result. Tenants who deposited security prior to the amendment's passage would be denied an equal right to collect interest with newer tenants, even though all tenants enjoy the same status of cestui que trust.<sup>126</sup> Nevertheless it must be recognized that the amendment makes no provision for such retroactive application.<sup>127</sup>

## VI. Enforcement Power for the Attorney General

A related and equally significant addition to the General Obligations Law is section 7-107,<sup>128</sup> which broadly increases the power of

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122. Office of the Attorney General, Press Release, July 26, 1974.

123. That is, does the amendment apply to a landlord who owns a building containing six or more units, who received security deposits prior to 1970, but who continues to hold the funds in non-interest bearing accounts?

124. 78 Misc. 2d 224, 356 N.Y.S.2d 809 (Sup. Ct. 1974). This action was a re-institution of *People v. Parker*, 30 N.Y.2d 964, 287 N.E.2d 618, 335 N.Y.S.2d 827 (1972) (*Parker I*) which was dismissed on the ground that the Attorney General had no standing to bring the suit. See note 133 *infra* and accompanying text. This decision, however, has been appealed. The appeal questions the decision of the New York Supreme Court which held that both section 7-103(2-a) and section 7-107 are applicable retroactively.

125. 78 Misc. 2d at 224, 356 N.Y.S.2d at 810.

126. The amendment did not alter the tenant's statutory status with respect to the landlord's holding of security deposits. Before and after the amendment the tenant is cestui que trust for deposits held by the landlord. The rights of tenants who deposited money prior to the amendment should, therefore, be the same as those who deposit moneys after the amendment was enacted.

127. N.Y. GEN. OBLIG. LAW § 7-103(2-a) (McKinney Supp. 1974).

128. Section 7-107, added by the Legislature in 1973, states: "If it appears to the attorney general that any person, association, or corporation has violated or is violating any of the provisions of title one of this article,



the Attorney General to bring suit for violations of related sections pertaining to security deposits. Previously, the state drew authority to prosecute from section 63(12) of the Executive Law.<sup>129</sup> Under that statute's test of "persistent fraud or illegality,"<sup>130</sup> the court in *New York v. Parkchester Apartments Co.*<sup>131</sup> refused to grant the Attorney General standing to sue. Tenants who had sought to compel defendant-landlord to pay interest on their security deposits were thus denied collective relief. The court in *Parkchester* held that a mere breach of contract—even had it existed—did not constitute an "illegal act" allowing the Attorney General to prosecute.<sup>132</sup> By the same reasoning, after the passage of the new interest provisions allowing individual tenants to bring suit, the court of appeals dismissed the Attorney General's suit for lack of standing<sup>133</sup> in *People ex. rel. Lefkowitz v. Parker*<sup>134</sup> (*Parker I*). The court, however, voiced its annoyance with the defendant for his failure to transfer security deposits into interest bearing accounts as required by law.<sup>135</sup> But the strongest support came from the dissent of Judge Jasen.<sup>136</sup>

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an action or proceeding may be instituted by the attorney general in the name of the people of the state of New York to compel compliance with such provisions and enjoin any violation or threatened violation thereof." *Id.* § 7-107.

129. Enacted in 1951, this law empowered the Attorney General to prosecute "whenever any person shall engage in repeated fraudulent or illegal acts or otherwise demonstrate persistent fraud or illegality, in the carrying on, or conducting, or transaction of business . . . ." N.Y. EXEC. LAW § 63(12) (McKinney 1972).

130. *Id.*

131. 61 Misc. 2d 1020, 307 N.Y.S.2d 741 (Sup. Ct. 1970).

132. *Id.* at 1026-27, 307 N.Y.S.2d at 748.

133. The Attorney General relied unsuccessfully upon N.Y. EXEC. LAW § 63(12) (McKinney 1972).

134. 30 N.Y.2d 964, 287 N.E.2d 618, 335 N.Y.S.2d 827 (1972).

135. The court of appeals left no doubt that sections 7-103(2-a) and (2-b) were applicable retrospectively. In dismissing the complaint solely on the ground that the Attorney General then lacked standing, the court said: "Dismissal is without prejudice to such other action or proceeding as . . . may be advised, by or on behalf of the tenants as owners of the deposits held in trust by the landlords, to compel compliance with [§ 7-103(2-a)] or to such other action or proceeding by public authority as may be authorized and appropriate." *Id.* at 965, 287 N.E.2d at 619, 335 N.Y.S.2d at 828.

136. The dissenting judges said that section 63(12) of the Executive

Obviously, the legislature intended to put an end to the nonsense of security deposit manipulation by landlords requiring that all rent security be deposited in interest bearing accounts. To construe the statute any other way would clearly defeat the remedial purpose intended.<sup>137</sup>

After passage of section 7-107, *Parker* was relitigated<sup>138</sup> and the Attorney General was successful in his reliance on the statute to enforce the landlord's duty to transfer deposits into interest bearing accounts.<sup>139</sup> Moreover, the court ordered defendant-landlord to pay his tenants over one hundred thousand dollars in interest accruing since 1970.<sup>140</sup>

The issue currently on appeal in *Parker II* concerns the lower court's holding that section 7-107 is applicable retroactively,<sup>141</sup> allowing the Attorney General to prosecute all prior and continuing violations of the security deposit legislation.<sup>142</sup> The *Parker* litigation has already been a catalyst for tenants' complaints to the New York Municipal Frauds Bureau.<sup>143</sup>

### VII. Transfer of a Security Deposit Upon Landlord's Conveyance of the Fee

Section 7-105 of the General Obligations Law complements the provisions of sections 7-103 and 7-107. It provides for the orderly transfer of deposits from a former holder to a new one. Violation of this section is a misdemeanor.<sup>144</sup>

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Law was sufficient to give the Attorney General standing to sue. *Id.* at 967, 287 N.E.2d at 619, 335 N.Y.S.2d at 829.

137. *Id.* at 966, 287 N.E.2d at 619, 335 N.Y.S.2d at 828.

138. *People ex rel Lefkowitz v. Parker*, 78 Misc. 2d 224, 356 N.Y.S.2d 809 (Sup. Ct. 1974).

139. See note 128 *supra* and accompanying text.

140. 78 Misc. 2d at 226, 356 N.Y.S.2d at 811.

141. See notes 123-27 *supra* and accompanying text.

142. The court said: "By its very terms it is applicable to past as well as future violations of Article 7. The only significance of its effective date (July 1, 1973) is that after that date the hand of the Attorney General was loosened. The section does not and appears not to have been intended to limit the People to policing only prospective violations of Article 7." 78 Misc. 2d at 225, 356 N.Y.S.2d at 811.

143. Interview with Meyer Menscher, Prosecutor for the Miscellaneous Frauds Bureau of the Office of the Attorney General of New York, in New York City, August 1, 1974.

144. N.Y. GEN. OBLIG. LAW § 7-105 (McKinney Supp. 1974).

This section was amended in 1974 to limit the holder's options in a transferral of a security deposit.<sup>145</sup> Upon conveyance of the fee, he will no longer be free to retain the money until termination of his lease, nor may he return the deposit directly to tenants. He must turn the security deposit over to the person assuming control of the property.<sup>146</sup> Moreover, the former holder is under a statutory duty to notify his tenants of the transaction.<sup>147</sup> However, the provisions of section 7-105 may be voided by prior agreement of the parties.<sup>148</sup>

The principle applied in section 7-105 is that the benefits of the personal covenant to pay a security deposit run with the land. The statute acknowledges the new owner's right to protection from a tenant's failure to perform the terms of a lease.<sup>149</sup> Thus, courts have held that a grantee of real estate is entitled to the benefits of a deposit made by a tenant to the original landlord.<sup>150</sup> Upon the tenant's default the new owner may sue his grantor for damages up to the amount of such deposit.<sup>151</sup> However, since the burden of the covenant to return a deposit is personal and does not run with the land,<sup>152</sup> a grantee of a fee who receives no security deposit cannot be held liable to a tenant for its return.<sup>153</sup> The only means by which the grantor-landlord may escape liability is by turning over the deposit in accordance with the dictates of the statute.<sup>154</sup> Minor noncompli-

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145. N.Y. GEN. OBLIG. LAW § 7-105(2)(McKinney Supp. 1974).

146. *Id.*

147. *Id.*

148. *Id.*

149. See *Halsted v. Globe Indem. Co.*, 258 N.Y. 176, 179 N.E. 376 (1932).

150. *Metropolitan Life Ins. Co. v. Stephen Realty Co.*, 178 Misc. 53, 33 N.Y.S.2d 146 (N.Y. City Ct. 1942); RASCH § 391.

151. *Metropolitan Life Ins. Co. v. Stephen Realty Co.*, 178 Misc. 53, 33 N.Y.S.2d 146 (N.Y. City Ct. 1942); *Donnelly v. Rosoff*, 164 Misc. 384, 298 N.Y.S. 946 (Mun. Ct. 1937).

152. *Mallory Associates v. Barving Realty Co.*, 300 N.Y. 297, 90 N.E.2d 468 (1949); *Joseph Fallert Brewing Co. v. Blass*, 119 App. Div. 53, 103 N.Y.S. 865 (2d Dep't 1907).

153. *Halsted v. Globe Indem. Co.*, 258 N.Y. 176, 179 N.E. 376 (1932).

154. N.Y. GEN. OBLIG. LAW § 7-105(1) (McKinney Supp. 1974).

155. *Tow v. Maidman*, 56 Misc. 2d 468, 288 N.Y.S.2d 837 (Sup. Ct. 1968). Here a tenant was aware of the name and address of the landlord's grantee, and subsequently made payments to the grantee of rents due

ance has been tolerated,<sup>155</sup> but courts have not tolerated any conveyance that poses a substantial risk to the tenant's security.<sup>156</sup>

The statute does not control the fate of a security deposit upon the tenant's assignment of a lease.<sup>157</sup> But the common law is clear that the landlord may retain any deposit made by the assignor-tenant to secure performance, unless the landlord were to discharge him by agreement.<sup>158</sup> Thus, the assignee does not have a right to the deposit held in trust for the assignor, unless the latter expressly relinquished his rights to the deposit upon fulfillment of the covenants of the lease.<sup>159</sup>

### VIII. Conclusion

The current litigation over interest has spurred new activity within the tenant associations of New York City. There has been an effort to publicize *Parker II* as a means of encouraging valid claims against recalcitrant landlords.<sup>160</sup> Indeed, the Municipal Frauds Bureau of the Attorney General's Office reports an increase of claims as a result of *Parker II*.<sup>161</sup>

The present activity in fact understates the frustrating problems tenants commonly encounter concerning their security deposits.

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under the lease. The fact that the notice of the deposit's transfer failed to give the grantee's name and address did not entitle tenant to recover his deposit.

156. *Stuarco, Inc. v. Slafbro Realty*, 30 App. Div. 2d 80, 289 N.Y.S.2d 883 (2d Dep't 1968), where a former landlord had transferred tenants' security to a grantee midway through a renewed lease. The court ordered him to pay tenants all interest that had actually accrued while the former landlord had been in possession. In *Purfield v. Kathrane*, 73 Misc. 2d 194, 341 N.Y.S.2d 376 (Civ. Ct. 1973), the court held that the notification provisions of sections 7-103(2) and 7-105(1)(a) had been violated, and found defendant-landlord liable for conversion.

157. N.Y. GEN. OBLIG. LAW § 7-105 (McKinney Supp. 1974).

158. *Piser v. Hecht*, 170 App. Div. 668, 156 N.Y.S. 601 (1st Dep't 1915).

159. *Shattuck v. Buek*, 158 App. Div. 709, 143 N.Y.S. 1045 (1st Dep't 1913); *Wertheimer v. Marks*, 81 Misc. 137, 142 N.Y.S. 331 (Sup. Ct. 1913).

160. Interviews with representatives of several New York City tenant's associations reflect an increasing number of complaints after publication of the decision in *Parker II*.

161. Interview with Meyer Menscher, prosecutor for the Miscellaneous Frauds Bureau of the Office of the Attorney General of New York, in New York City, August 1, 1974.

Often the disputes concern relatively small sums of money. A tenant, uncertain of his rights, may be reluctant to file a complaint or bring suit himself. He may feel that the specter of a protracted dispute imposes a greater burden than it is worth. Thus, an individual tenant, with relatively little at stake, and with only the desire to be finished with the whole distasteful business, is tempted to give up and forget, if not forgive.

The statute has done much to improve the lot of the tenant and to eliminate many of the inequities that existed at common law.<sup>162</sup> Where the landlord once was regarded as merely the tenants' debtor, he now occupies the position of trustee.<sup>163</sup> Where he was once allowed to play fast and loose with the tenants' security, he must now, at the very least, segregate the deposit and keep it intact.<sup>164</sup> He is even required, in some instances, to place the security in an interest bearing account.<sup>165</sup> Tenants should be made aware that in these situations they have the protection of the law, and that the literal language of the lease is not the final word.

As substantial as these revisions may have been, they are not sufficient. While a tenant is afforded a remedy for conversion of his security, this remedy is inadequate. Confronted with the expense of litigation, the individual tenant may abandon all efforts to seek redress. His vehicle of enforcement becomes, in effect, no vehicle at all. With regard to a landlord's conversion, it is not clear that the tenants' statutory remedy strengthens their prior position.<sup>166</sup> An alternative method of enforcement must be made available to tenants. It is submitted that a criminal sanction, or at least a monetary civil penalty, should be enacted into law to halt a landlord's repeated conversions of security deposits for his own purposes.<sup>167</sup>

There should also be a re-examination of the decisions which allow a landlord to temporarily commingle the tenant's security with his personal funds without being subject to liability.<sup>168</sup> The

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162. See notes 41-47 *supra* and accompanying text.

163. See notes 42-44 *supra* and accompanying text.

164. See note 44 *supra* and accompanying text.

165. See note 109 *supra* and accompanying text.

166. See notes 66-70 *supra* and accompanying text.

167. See notes 72-73 *supra* and accompanying text.

168. See notes 60-62 *supra* and accompanying text.

statute should not be open to such interpretation.<sup>169</sup> That such holdings are wooden and restrictive is demonstrated by the tenant who sues for the conversion of his security, only to have the landlord segregate the deposit prior to conclusion of the trial.

Recent decisions have also established the independence of the duty to pay rent from the duty to segregate the tenants' security.<sup>170</sup> The statute was enacted to deal with a practical problem,<sup>171</sup> and its effectiveness will only be eroded by continued judicial acceptance of this principle.

For some tenants the development of security deposit law can mean very little, perhaps the gain of a few dollars that were not likely to be missed. Yet this is not to say that a stronger law will not be felt.

The law of landlord-tenant is *the law* to most low income dwellers, and it instructs them everyday on the value society places on basic fairness and the social classes it prefers.<sup>172</sup>

It is for these people, the low income dwellers, that security deposit legislation assumes particular importance.

Stevens Ingraham  
Paul J. Yesawich, III

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169. See notes 63-65 *supra* and accompanying text.

170. See cases cited notes 66-67 *supra*.

171. The legislature's primary purpose was to establish that landlords were to be trustees of a tenant's money and not creditors free to use the money for their private ends. See note 46 *supra* and accompanying text.

172. Quinn & Phillips, *The Law of Landlord-Tenant: A Critical Evaluation of the Past with Guidelines for the Future*, 38 *FORDHAM L. REV.* 225, 258 (1969).

