

Rent Deposit Deeds: held by trust or by charge?

Introduction

Rent deposits are a popular type of security taken by landlords to insure against the risk of a tenant failing to pay rent or breaching certain covenants in the lease.

A rent deposit is a sum of money (usually equalling between 6 and 12 months' gross rent) paid by the tenant and accessible by the landlord in circumstances agreed between the parties. The circumstances are usually non-payment of rent or breach of tenant covenants. The document setting out the rent deposit agreement is usually a rent deposit deed.

When drafting the deed, a landlord will require that money is quickly and easily accessible if the tenant fails to pay rent or breaches a certain covenant. The tenant will require that the full deposit is quickly and easily recoverable at the end of the term or earlier on the satisfaction of specified conditions. Both parties will require full protection of the deposit in the event of the other's insolvency.

The two most common methods of holding a rent deposit are by a charge or by a trust. This Briefing will assess the advantages and disadvantages of both.

Charge method

Under the charge method, the deposit is paid by the tenant to the landlord and held in a separate bank account controlled by the landlord. The tenant retains the contractual right to be repaid by the bank and the landlord takes a fixed legal charge over this right. If the tenant fails to pay rent

or breaches certain covenants in the lease, the landlord can withdraw monies from the account. Otherwise, the charge will expire at the end of the term (or earlier on satisfaction of specified conditions) and the deposit is repaid to the tenant.

Landlord's perspective

The landlord retains control and supervision by holding the deposit in its own account. In the event of a tenant's breach, the landlord can quickly and easily withdraw from the account. As the landlord is a secured creditor, the deposit is protected from the tenant's insolvency.

Deeds created on or after 1st October 2009 and before 6th April 2013 may need to be registered with Companies House to be enforceable. This administrative burden does not apply to deeds created on or after 6th April 2013.

Tenant's perspective

By the tenant retaining ownership, the deposit is protected from the landlord's insolvency. This also prevents the bank from using the deposit to set off other debts owed to the bank by the landlord. To avoid confusion with the bank or any insolvency practitioner, the account should contain the name of the tenant.

Unlike a trust, a charge will not impose fiduciary duties. The landlord is only bound by obligations expressly set out in the deed. This may be problematic for tenants as it is harder to expressly agree obligations with a landlord and there is no safety net for drafting omissions.

Trust method

The trust method is practically very similar to the charge method. As above, the deposit is paid by the tenant to the landlord and held in a separate bank account controlled by the landlord. Unlike above, the landlord is the legal owner of the deposit and the tenant retains the beneficial interest. The landlord is under a strict duty to manage the deposit in accordance with the terms of the trust. The circumstances permitting the landlord to withdraw from the deposit are the same as with the charge.

Landlord's perspective

As with the charge method, the landlord retains control and supervision by holding the deposit in its own account. In the event of a tenant's breach, the landlord can quickly and easily withdraw from the account. There is no requirement for the arrangement to be registered.

Importantly, the creation of a trust imposes fiduciary duties upon the landlord such as the duty to earn a reasonable rate of interest and to account to the tenant. These duties exist even where the deed is silent and may be seen as an onerous and potentially unfamiliar burden on the landlord. If the landlord breaches a fiduciary obligation there may be personal liability which continues long after any breach.

Tenant's perspective

By the tenant retaining a beneficial interest, the deposit is protected from the landlord's insolvency. Provided that the bank is aware of the tenant's interest, the deposit cannot be used to set off other debts owed to the bank by the landlord. The fiduciary duties imposed on the landlord give the tenant greater security that the deposit will not be misappropriated. If however the deposit is misappropriated, the creation of a trust better enables the tenant to trace and recover it. As fiduciary duties exist without express agreement, the tenant is not burdened with having to negotiate them into the deed and is better protected from drafting omissions.

Where the deposit is mixed with other money, it is unidentifiable and so the trust is ineffective. The tenant must therefore ensure that the landlord holds the deposit in a separate account and that

the deposit is easily identifiable. This creates an additional burden on the tenant.

Conclusion

Rent deposits will continue to be a popular means for landlords to protect themselves in a continuing climate of uncertainty.

The circumstances of the parties will dictate the appropriate form of a deed. However the trust method may confer greater obligations upon the landlord and can be seen as more tenant friendly.

As existing arrangements are tested by the courts and new arrangements are created, landlords and tenants should review their preferences to ensure the safety of their positions.

If you wish to discuss the appropriate method for your business, please contact the Commercial Real Estate and Licensing Department at Winckworth Sherwood.

For further information, please contact:



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