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Are Security Deposits "Security Interests"? The Proper Scope of Article 9 and Statutory Interpretation in Consumer Class Actions

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Assume that Jane Doe leases an automobile from a General Motors dealer, pursuant to a lease contract under which Jane makes a cash security deposit. Under the lease, the lessor agrees to "refund" the deposit at the conclusion of the lease term in the event that Jane fully performs her obligations under the lease. Is this transaction governed by Article 9—i.e., has the lessor taken a "security interest" in Jane's cash deposit to secure Jane's obligations under the lease agreement?

A cursory review of the text of Article 9 suggests that Jane's lessor would hold a possessory security interest in Jane's deposit. The official 1972 text (applicable prior to July 1, 2001) provided that Article 9 applied "to any transaction (regardless of its form) which is intended to create a security interest in personal property or fixtures."[1] In turn, Section 1-201(37) defines "security interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation."[2] Read together, these two provisions appear to encompass an automobile lease security deposit. When the automobile lessor contracts for and receives a cash security deposit from Jane, the lessor has taken an "interest" in Jane's "personal property." Furthermore, the security deposit unquestionably secures Jane's obligation as lessee to make the bargained-for lease payments and to maintain the physical condition of the automobile. As a result, it appears that Jane's lessor has taken a possessory security interest in the deposited funds and that Article 9 would govern the parameters of the lessor's rights and responsibilities with respect to this deposit. Certainly, those of us who

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1. U.C.C. § 9-102(1)(a) (1972). During the 1990s, Article 9 underwent a comprehensive revision, promulgated in 1999 (with technical corrections promulgated in January 2000) and effective in all 50 states as of July 1, 2001. The scope provision of revised Article 9 is as broad as (if not broader than) the scope provision of the 1972 text. Revised Article 9 applies to a "transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." U.C.C. § R9-109(a)(1) (2000). In this article, citations to revised Article 9 will be indicated by the prefix R9.

2. U.C.C. § 1-201(37) (1999).

teach Article 9 would expect (or hope for) our students to evaluate the situation precisely this way.

Nevertheless, while the textual analysis of this hypothetical seems straightforward, recent case law has surprisingly trended toward the opposite conclusion. In the past five years alone, courts in Alabama,[3] Illinois,[4] Kentucky,[5] Minnesota,[6] New York,[7] Ohio,[8] and Wisconsin[9] have concluded that the lessor's taking of a security deposit *does not* create a security interest in the deposited funds. What explains a set of decisions so profoundly and consistently at odds with the text of Article 9's broad scope provisions?

To make any sense of these recent decisions, one must first appreciate the context in which these disputes typically arise. If Jane's security deposit is treated as Article 9 "collateral"[10] subject to a possessory security interest in favor of Jane's lessor, then Article 9's baseline rules[11] will generally govern the rights and responsibilities of Jane's lessor with respect to the deposited funds. Article 9's baseline rules provide that if a secured party holds a possessory security interest in collateral and receives a monetary return on that collateral, the secured party must either apply this return against the debt or remit it to the debtor, unless the parties' own agreement expressly provides otherwise.[12] Thus, if Jane Doe's

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3. Yeager v. GMAC, 719 So. 2d 210 (Ala. 1998).

4. Spina v. Toyota Motor Credit Corp., 703 N.E.2d 484 (Ill. App. Ct. 1998).

5. Lawson v. Bank One, Lexington, N.A., 35 F. Supp. 2d 961 (E.D. Ky. 1997).

6. Rosen v. PRIMUS Auto. Fin. Servs., 618 N.W.2d 606 (Minn. Ct. App. 2000).

7. *In re* Ford Motor Credit Co. Motor Vehicle Lease Litig., No. 95 CIV. 1876, 1998 WL 159051 (S.D.N.Y. Apr. 1, 1998).

8. Dolan v. GMAC, 739 N.E.2d 848 (Ohio Ct. App. 2000); Knight v. Ford Motor Credit Co., 735 N.E.2d 513 (Ohio Ct. App. 2000).

9. Doe v. GMAC, 635 N.W.2d 7 (Wis. Ct. App. 2001).

10. Article 9 defines "collateral" as "the property subject to a security interest." U.C.C. § 9-105(1)(c) (1972); U.C.C. § R9-102(a)(12) (2000).

11. In contract law, one typically would use the term "default rule" to identify the rule that would govern the parties' rights and responsibilities absent a contrary agreement between the parties. This terminology could produce confusion in the Article 9 context, where the term "default rule" could also refer to a rule or principle that might apply in the event of the debtor's default under its security agreement. This Article uses the term "baseline rule" instead of "default rule" in order to avoid any such confusion.

12. U.C.C. § 9-207(2)(c) (1972). The 1972 text provided that "[u]nless otherwise agreed, when collateral is in the secured party's possession . . . the secured party may hold as additional security any increase or profits (except money) received from the collateral, but money so received, unless remitted to the debtor, shall be applied in reduction of the secured obligation." *Id.* Revised Article 9 rearticulates this same basic standard in slightly modified language: "a secured party having possession of collateral . . . shall apply money or funds received from the collateral to reduce the secured obligation, unless remitted to the debtor." U.C.C. § R9-207(c)(2) (2000).

Section R9-207(c) does not contain the "unless otherwise agreed" language used lessor placed her security deposit in an interest-bearing deposit account, and the security deposit is Article 9 "collateral," then the lessor must either apply the interest earned by that deposit to reduce Jane's lease obligation or pay that earned interest to Jane—again, unless the parties have opted out of Article 9's baseline rules through contrary lease provisions[13] (or unless some other positive law governs payment of interest on the deposit).[14]

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in the 1972 text to signal that the parties could contract out of these baseline rules. Nevertheless, the comments to Section R9-207(c) make clear that the quoted language merely establishes "rules following common-law precedents which apply unless the parties otherwise agree." U.C.C. § R9-207 cmt. 3 (2000).

Because there is no meaningful difference between Section 9-207(2)(c) of the 1972 text and revised Section R9-207(c)(2), the analysis of the issues presented in the security deposit cases would not differ depending upon whether a particular dispute was governed by Revised Article 9 or the 1972 text. For purposes of conciseness, this article generally will refer simply to "Section 9-207" without distinguishing between the 1972 text and Revised Article 9.

13. As discussed in the text accompanying notes 61-66, *infra*, Article 9 does not impose on the secured party any affirmative obligation to invest the collateral so as to earn a monetary return. It merely requires that the secured party must account for any monetary return actually received, unless the parties have contracted otherwise.

14. State statutes could effectively pre-empt the potential application of Section 9-207 relative to the issue of interest on security deposits. Statutes in some states place an immutable positive obligation upon certain lessors to pay interest to the lessee upon the lessee's security deposit. For example, see *infra* note 67 for a list of state statutes requiring landlords to pay interest upon tenant security deposits.

In the consumer lease context, very few presently existing state statutes have expressly resolved the interest-on-security-deposit question. Illinois requires that any consumer lessor must place any security deposit in a bank account holding only security deposits, and further provides that if that account bears interest, such interest must be paid "to the party entitled to the deposit at the end of the lease" (the tenant, assuming no default) if the deposit was $150 or more. 815 ILL. COMP. STAT. § 165/3 (1999). Under New York law, if a personal property lease agreement has a term of 120 days or longer and requires a deposit of $750 or more, the lessor must place the deposit in an interest-bearing account; all interest earned belongs to the lessee with the exception of an administrative fee (1% of the deposited amount) that the lessor may impose. N.Y. GEN. OBLIG. LAW § 7-101(1), (1-a) (McKinney Supp. 2002). The landlord cannot disclaim this obligation in the lease. *Id.* § 7-101(2). In all other cases, any interest actually earned by the lessor must be paid to the lessee (after the allowed administrative fee). *Id.* § 7-101(1). By contrast, Wisconsin statutes make clear that the holder of a security deposit under a consumer lease need not pay interest on a security deposit. WIS. STAT. ANN. § 429.203(9) (West 1998).

In February 2002, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Consumer Leases Act, which (if adopted by a state) would appear to establish that the lessor in a consumer lease need not pay interest on a security deposit. Uniform Consumer Leases Act § 303(d) (2002).

Accordingly, if Jane's lease is silent on the subject and the lessor has actually earned a monetary return on Jane's deposit during the lease term, Jane might well demand that the lessor return her deposit with interest earned at the conclusion of the lease term. If the lessor refused, Jane would have little financial incentive to seek individual legal action to compel payment of interest; the legal costs associated with such an action would far exceed the amount of interest earned on Jane's relatively small deposit.[15] However, Jane might instead choose to proceed via a consumer class action, on behalf of herself and all other similarly situated lessees—allowing Jane to assert a collective claim that no individual lessee could pursue efficiently.

Nevertheless, if Jane attempts to bring a consumer class action seeking to vindicate her claim to collect interest earned on her security deposit, the trend of recent decisions suggests that Jane's attempt will fail. As noted above, recent decisions in at least seven states have concluded that Article 9 does not apply to a lessor's security deposit, on the theory that a security deposit creates merely a "debt" rather than a security interest. These courts have consistently concluded that Article 9's baseline rules regarding monetary returns on collateral do not apply to lease security deposits, and that instead the lessor's responsibility is governed by common law principles—under which the lessor need not pay interest on security deposits absent an express statutory obligation or a contrary contractual agreement to do so.

Part I of this article critiques this strand of decisions (referred to collectively throughout the article as the "security deposit cases") and demonstrates that the cases rest upon a flawed understanding of Article 9's scope provisions. In these cases, courts have borrowed landlord-tenant law's traditional distinction between a "debt" and a "pledge"—a distinction used in landlord-tenant law to justify a baseline rule under which title to a security deposit passes entirely to the landlord, with the landlord having no positive duty to invest the deposit or pay interest to the tenant.[16] As Part I explains, the security deposit cases wrongly conclude that the drafters of Article 9 intended to incorporate this distinction and exclude lease security deposits from Article 9's scope. As Part I demonstrates, the reasoning of these cases necessarily exalts form over substance to a level that one cannot reconcile with Article 9's scope provisions—the interpretation of which should be guided by economic substance rather than form.[17] As Part I concludes, courts should treat lease security deposits as Article 9 security interests and resolve the "interest on security deposits" issue by reference to

15. For example, if the lessor of a vehicle for a three-year term invested a $300 security deposit in an account earning a 4% annual return, this deposit would earn roughly $37.50, depending upon the method of compounding.

16. *See infra* text accompanying notes 22-68.

17. *See infra* text accompanying notes 69-77.

Section 9-207 (except where other positive law or the parties' contrary agreement displace Section 9-207's applicability).[18]

Properly treating lease security deposits as security interests, however, should not have produced a different ultimate result in most of the security deposit cases. Even assuming Article 9 governs security deposits, the courts should have denied recovery to plaintiff lessees in the security deposit cases on alternative grounds.[19] Further, as noted above, lessors can readily contract out of any liability for paying interest on security deposits (unless legislation other than Article 9 imposes a positive nonwaivable duty to pay interest). Finally, recently proposed uniform consumer leasing legislation would (if adopted) relieve consumer lessors from any obligation to pay interest on security deposits. As such, why should anyone care about the improper analysis present in the security deposit cases?

In addressing this question, Part II explores the possibility that the security deposit cases reflect latent judicial bias over perceived abuse of the consumer class action device and judicial frustration with the lack of legislative solutions to these perceived abuses.[20] As Part II explains, this speculation appears consistent with other contexts in which anti-consumer class action bias appears (at least anecdotally) to have influenced statutory interpretation in consumer class action disputes.[21] As a result, further empirical study may be useful to indicate whether anti-consumer class action bias systematically influences statutory interpretation generally (i.e., not just in UCC decisions), and what implications such a bias should have for legislative reforms.

I. THE SECURITY DEPOSIT CASES (AND WHY THEY'RE WRONG)

Since 1997, courts in at least seven states have concluded that Article 9 does not apply to security deposits created under an automobile lease.[22] The various cases are factually similar, and each is roughly comparable to the hypothetical set forth in the introduction. Many of the decisions merely rely upon earlier opinions in other states, without undertaking significant independent analysis. Thus, rather than summarize all of the decisions, Part I.A looks at two

18. *See infra* text accompanying notes 78-112.

19. *See infra* text accompanying notes 79-111.

20. *See infra* text accompanying notes 113-56.

21. *See infra* text accompanying notes 157-92.

22. *See* Yeager v. GMAC, 719 So. 2d 210 (Ala. 1998); Spina v. Toyota Motor Credit Corp., 703 N.E.2d 484 (Ill. App. Ct. 1998); Lawson v. Bank One, Lexington, N.A., 35 F. Supp. 2d 961 (E.D. Ky. 1997); Rosen v. PRIMUS Auto. Fin. Servs., 618 N.W.2d 606 (Minn. Ct. App. 2000); *In re* Ford Motor Credit Co. Motor Vehicle Lease Litig., No. 95 CIV. 1876, 1998 WL 159051 (S.D.N.Y. Apr. 1, 1998); Dolan v. GMAC, 739 N.E.2d 848 (Ohio Ct. App. 2000); Knight v. Ford Motor Credit Co., 735 N.E.2d 513 (Ohio Ct. App. 2000); Doe v. GMAC, 635 N.W.2d 7 (Wis. Ct. App. 2001).

of these decisions—*Knight v. Ford Motor Credit Co.*[23] and *Yeager v. GMAC*[24]—in which state courts have attempted to provide an analytical defense for excluding security deposits from Article 9.[25] In Part I.B, the article critiques these decisions, demonstrating how courts have inappropriately borrowed from landlord-tenant law to reach the unjustified conclusion that Article 9 excludes security deposits from its scope. In Part I.C, the article explains why the misinterpretation of Article 9's scope provisions in the security deposit cases is particularly egregious—in fact, a correct application of Article 9's provisions would impose no liability upon the typical automobile lessor/assignee, if its behavior in handling security deposits is consistent with customary industry practices. As a result, Part I concludes that there is no apparent functional reason for courts to adopt the incorrect interpretation of Sections 1-201(37) and 9-207 reflected in the security deposit cases.

A. *Representative Security Deposit Cases*

1. *Knight v. Ford Motor Credit Co.*

In 1995, Michael A. Knight leased a Ford Windstar from Ed Mullinax Ford in Amherst, Ohio, executing a lease that provided for a $225 security deposit.[26] Mullinax assigned the lease to Ford Motor Credit Company ("Ford").[27] At a date unspecified by the court (but presumably upon conclusion of the lease), Knight sued to recover sums earned on his security deposit under Ohio's version of Section 9-207 and sought class certification on behalf of similarly situated lessees.[28] Knight argued that the security deposit was personal property belonging to him, and that its purpose was to secure payment or performance of his obligations under the lease.[29] As a result, Knight argued, the deposit was "a security interest under Ohio law" and Section 9-207 therefore governed Ford's responsibilities with respect to that deposit.[30] The trial court rejected Knight's argument and granted summary judgment for Ford.

The Ohio Court of Appeals affirmed, concluding that Knight's security deposit did not create a "security interest" governed by Article 9, but instead

23. 735 N.E.2d 513 (Ohio Ct. App. 2000).

24. 719 So. 2d 210 (Ala. 1998).

25. *See infra* text accompanying notes 26-50.

26. *Knight*, 735 N.E.2d at 514. Knight did not actually pay this amount by cash or check; rather, he received a credit for that sum based upon the stipulated value of his trade-in vehicle.

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.* at 516.

merely a "debt" governed by Ohio common law. The court observed that "[t]o hold that a security deposit creates a security interest, i.e., a pledge, would derogate the common law principle that a security deposit instead creates only a debt."[31] For this principle, the court cited the venerable treatise *Friedman on Leases*, which states that under landlord-tenant law, "[i]n most cases a security deposit has been held to create a debtor-creditor relation between landlord and tenant"[32] and that in such a relationship "there is no implied obligation to pay interest on the deposit."[33] The *Knight* court reasoned that this common law principle was so well-established that Article 9's drafters had to have been understood to have incorporated it into Section 9-207. The court also noted that Ohio's version of UCC Article 2A governing lease contracts placed no explicit positive duty upon lessors to pay interest on security deposits, and from this fact the *Knight* court drew what it considered the logical negative inference—that if the Ohio legislature had intended to obligate lessors to pay lessees interest on security deposits, it would have done so expressly:

> When the General Assembly has intended to impose an obligation to pay interest on security deposits, it has done so explicitly and not in an oblique manner as the plaintiff contends was done in [Section 9-207(2)]. Therefore, we conclude that it was not the legislative intent that lessors of automobile leases be obligated to pay the lessee interest or profits earned on the security deposits.[34]

As a result, the *Knight* court—relying extensively upon the weight of prior decisions in other jurisdictions—concluded that Article 9 did not displace the common law distinction between a "debt" and a "pledge." Further, the court concluded that in adopting Section 9-207(2), the Ohio legislature essentially accepted (and incorporated) the common law principle that a security deposit creates only a debt—thereby relieving the lessor of any duty to pay interest on that deposit.

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31. *Id.* at 517.

32. 2 MILTON R. FRIEDMAN, FRIEDMAN ON LEASES § 20.4, at 1291 (4th ed. 1997).

33. *Id.* § 20.4, at 1292.

34. *Knight*, 735 N.E.2d at 516 (citing OHIO REV. CODE ANN. § 5321.16 (1989) (requiring interest on real property lease security deposits in certain conditions); *id.* § 3733.18 (1999) (requiring interest on manufactured home park and marina rental security deposits)).

2. *Yeager v. GMAC*

In May 1995, Richard Yeager leased an automobile from Solomon Chevrolet ("Solomon") and made a refundable security deposit of $350 pursuant to the lease. The lease provided, in pertinent part:

> 29. SECURITY DEPOSIT. A refundable security deposit may be part of the payment you make when you sign this Lease. We will deduct from the security deposit any amounts you owe under this Lease and do not pay. After the end of this Lease, we will refund to you any part of the security deposit that is left.[35]

Solomon assigned the lease to GMAC. The opinion does not explain whether GMAC took possession of the security deposit, or whether either GMAC or Solomon actually invested the deposit in an interest-bearing account.[36]

In June 1996, Yeager sued GMAC and Solomon on behalf of himself and similarly situated lessees, alleging that Alabama's version of Section 9-207 obligated GMAC and Solomon to pay Yeager interest on his security deposit.[37]

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35. Yeager v. General Motors Acceptance Corp., 719 So. 2d 210, 210 (Ala. 1998).

36. Other decisions indicate that GMAC has followed differing practices. In *Doe v. GMAC*, the opinion states that GMAC placed the deposit in question "into a non-interest bearing account and commingled it with other GMAC funds." Doe v. GMAC, 635 N.W.2d 7, 9 (Wis. Ct. App. 2001). By contrast, in *Dolan v. GMAC*, GMAC argued that it never took possession of the deposit; instead, it argued that it merely credited the deposit against GMAC's purchase of the lease and the vehicle from the lessor. Dolan v. GMAC, 739 N.E.2d 848, 850 (Ohio Ct. App. 2000). This latter approach is consistent with the typical practice of Ford Motor Credit Company, as described in *Knight v. Ford Motor Credit Co.*, 735 N.E.2d 513, 514-15 (Ohio Ct. App. 2000):

> Ford Credit states that it receives no money for motor vehicle lease security deposits. Plaintiff's payment of a security deposit to the dealer creates a debt that the dealer and, after assignment, Ford Credit owes plaintiff as lessee. That debt is transferred from the dealer to Ford Credit by means of the discount Ford Credit pays the dealer in purchasing the leased automobile. The amount Ford Credit pays to the dealer in purchasing the leased automobile is discounted by the amount of the security deposit and the first month's lease payment paid by a lessee to the dealer. Ford Credit never receives possession of a check or other tangible form of payment representing plaintiff's lease security deposit.

Id. at 518.

37. Yeager also alleged that GMAC and Solomon breached the disclosure requirements of the Consumer Leasing Act, 15 U.S.C. § 1667a (2000), by failing to disclose that they would not pay interest on Yeager's security deposit. The disclosure provision in 15 U.S.C. § 1667a does not expressly mandate disclosure with regard to handling of security deposits or payment of interest on such deposits. Only one court decision has interpreted the Consumer Leasing Act to require disclosure regarding

Yeager argued that Article 9 defines a "security interest" as "an interest in personal property . . . that secures payment or performance of an obligation," and that "personal property" includes "money." Further, Yeager argued that the terms of the lease and the use of the label "security deposit" demonstrated that Solomon and GMAC intended for the $350 deposit to secure Yeager's obligations under the lease. Yeager thus asserted that the deposit constituted a possessory security interest in Yeager's money—thereby implicating Section 9-207(2) and obligating GMAC to remit to Yeager (or apply to the debt) any money "received from the collateral."[38] In support of his argument, Yeager pointed to federal court decisions in Illinois[39] and New York[40] holding that Section 9-207 applied to security deposits under automobile leases.

In their answer, GMAC and Solomon argued that although the lease contract specified that the funds constituted a "deposit" subject to "refund,"[41] the lease contract actually transferred outright ownership of the funds to Solomon—with the result that Yeager retained no legal interest whatsoever in the deposited funds. Instead, the defendants argued, Yeager merely "held a contract right to have an equivalent amount of money, or some lesser amount, returned to him at the termination of the lease."[42] According to the defendants, the deposit created only a "debt," not a "pledge of collateral," and the lease in no way indicated any intention to create a security interest in the deposited funds. The defendants thus argued that the deposit could not constitute "collateral" within the meaning of Article 9, that Section 9-207 did not govern their rights and responsibilities with respect to the deposit, and that the lessor had no obligation under Alabama common law to pay interest on a security deposit.[43]

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payment of interest on security deposits, *see* Werbosky v. Ford Motor Credit Co., 38 U.C.C. Rep. Serv. 2d 596 (S.D.N.Y. 1996), and the same court later reversed its decision. *See In re* Ford Motor Credit Co. Motor Vehicle Lease Litig., No. 95 CIV. 1876, 1998 WL 159051 (S.D.N.Y. Apr. 1, 1998).

38. *Yeager*, 719 So. 2d at 211.

39. Demitropoulos v. Bank One Milwaukee, N.A., 924 F. Supp. 894 (N.D. Ill. 1996); Demitropoulos v. Bank One Milwaukee, N.A., 953 F. Supp. 974 (N.D. Ill. 1997). The *Demitropoulos* case is one of the only recent cases (and the only one not later overruled) in which the court correctly analyzed a security deposit as being within the scope of Article 9.

40. Werbosky v. Ford Motor Credit Co., 38 U.C.C. Rep. Serv. 2d (CBC) 596 (S.D.N.Y. 1996). Although the district court in *Werbosky* initially ruled that a security deposit created a "security interest" governed by Article 9, the same court later reversed this ruling and concluded that under New York law, a lease security deposit created only a debt rather than a security interest. *In re* Ford Motor Credit Co. Motor Vehicle Lease Litig., No. 95 CIV. 1976, 1998 WL 159051, at *4 (S.D.N.Y. Apr. 1, 1998).

41. *See supra* text accompanying note 35.

42. *Yeager*, 719 So. 2d at 211.

43. *Id.* at 210.

The trial court granted summary judgment in favor of the defendants, and the Alabama Supreme Court unanimously affirmed.[44]

In contrast to the decision in *Knight*—which, like most of the security deposit cases, concluded as a matter of law that Article 9 does not apply to a lease security deposit—the *Yeager* court suggested that the dispute presented a question of fact: did the parties' lease agreement manifest a sufficient intention to create a security interest in the deposit? If so, the *Yeager* court suggested, then Article 9 would apply.[45] In this regard, the court's approach in *Yeager* was consistent with existing Alabama Supreme Court precedent in *General Electric Credit Corp. v. Alford & Assocs.*,[46] where the court held that Section 9-207 governed reserve accounts held on deposit by GECC under a retail financing agreement.[47] Nevertheless, the *Yeager* court distinguished *Alford* on the merits—concluding that while the agreement in *Alford* had "specifically" expressed the parties' intention to create a security interest in the reserve accounts, Yeager's automobile lease lacked any such "specific" expression of intent:

> If no such intent is specifically expressed in the agreement, then no security interest is created .... [W]e find no such intent specifically expressed in the language of the lease agreement executed between Yeager, GMAC, and Solomon Chevrolet. The language of the lease, with respect to security deposits, *does not expressly and specifically indicate that the parties intended to create a security agreement.*[48]

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44. *Id.* at 213.

45. *Id.* at 212-13.

46. 374 So. 2d 1316 (Ala. 1979).

47. The plaintiff in *Alford* operated a mobile home sales business for which GECC provided both wholesale and retail financing. *Id.* at 1318. The retail financing agreement provided that GECC could establish "a time sales security reserve or such other reserve or reserves" as GECC deemed necessary, as security for Alford's performance under the financing agreements. *Id.* at 1319. When GECC later terminated the wholesale agreement and sued for sums allegedly unpaid pursuant to that agreement, Alford argued that GECC was obligated to credit to Alford whatever sums GECC had earned on the reserve accounts. *Id.* The *Alford* court agreed, concluding that "[t]he intent to create a security interest in the reserve funds is specifically spelled out in the retail financing agreement, wherein it is stated: 'It is agreed that such reserves are to be held as security for and not in lieu of performance.'" *Id.* at 1322. The *Alford* court, thus, held that "the record shows a clear and unequivocal intention to create a security interest in personal property (*i.e.*, money)," and that Section 9-207(2) obligated GECC to account to Alford for profits earned on the reserve accounts. *Id.* at 1322-23.

48. *Yeager*, 719 So. 2d at 213 (emphasis added).

The *Yeager* court thus concluded that Section 9-207 did not apply to Yeager's security deposit, which was, therefore, governed by Alabama common law—under which the lessor had no positive obligation to pay interest on the deposit.[49] The court thus affirmed the summary judgment in favor of GMAC and Solomon.[50]

B. Critiquing the Security Deposit Cases

Neither *Knight* nor *Yeager* makes a compelling argument for the conclusion that Article 9 excludes lease security deposits from the scope of its coverage. Like *Yeager* and the other recent security deposit decisions, *Knight* placed determinative significance upon the distinction between a "pledge" and a "debt." The court in *Knight* viewed these characterizations to be mutually exclusive—either the security deposit is a "pledge" (with the lessor holding an Article 9 security interest in the deposit) or it is a "only a debt" (to which Article 9 does not apply). There are three problems with this conclusion. First, the court misunderstood the context in which this pledge/debt distinction developed, and, thus, misapplied the distinction to the facts of the dispute in *Knight*.[51] Second, regardless of the status of the pledge/debt distinction under landlord-tenant law, the distinction becomes irrelevant within the framework of Article 9, because the plain terms of Article 9 sweep security deposits within its scope.[52] Third, uncritical acceptance of the traditional common law "no-interest-on-security-deposit" rule has discouraged courts from engaging in serious economic analysis of whether that remains an appropriate baseline rule in interpreting consumer leases.[53]

1. The Historical Origins of the Pledge/Debt Distinction

While there is a consistent body of pre-Code law holding that a security deposit creates merely a debt as distinguished from a pledge, it is important to understand the context in which landlord-tenant law developed that distinction. Traditionally, landlords commingled security deposits with their own funds and used security deposits (and any income earned on such deposits) for their own accounts. In evaluating legal challenges to such landlord conduct, common law courts articulated three different approaches—characterizing the transaction as creating either a "trust," a "pledge," or a "debt."

49. *Id.*
50. *Id.*
51. *See infra* notes 54-68 and accompanying text.
52. *See infra* notes 69-77 and accompanying text.
53. *See infra* notes 78-81 and accompanying text.

A very few courts treated security deposits as presumptively establishing a trust of tenant property, with the landlord's responsibilities relating to the deposit governed by trust law principles. Under this view, a landlord's commingling and use of a security deposit for its own account would presumptively violate the tenant's property rights in that deposit. Furthermore, trust law would oblige the landlord/trustee to invest the deposit for the benefit of the tenant, and would hold the landlord/trustee liable for its failure to do so. Because leases typically did not establish an express trust relationship with respect to the security deposit—and given the practical difficulty associated with viewing the landlord-tenant relationship as fiduciary in nature—very few common law decisions characterized a security deposit as a trust.[54]

Alternatively, a slightly larger number of courts treated the security deposit as a "pledge" of the tenant's property—with the landlord's responsibilities respecting that deposit being governed by the common law relating to pledges. Under this view, advanced principally by New Jersey and California decisions,[55] the landlord could legally commingle the deposit with its own operating funds. Further, the landlord as pledgee *was under no positive duty to invest the deposit* to earn interest on the tenant's behalf. Nevertheless, under the law governing pledges, the landlord could not permanently dispose of the deposit (at least for any reason unrelated to the tenant's obligations under the lease). Further, while

54. Predominately, these decisions occur in New York courts. *See, e.g.*, Donnelly v. Rosoff, 298 N.Y.S. 946, 948 (Mun. Ct. 1937) ("a deposit so made by a tenant with his landlord constitutes a trust fund, held by the landlord merely to secure the payment of rent and the performance of the covenants of the lease"); *see also* Fore Improvement Corp. v. Selig, 278 F.2d 143 (2d Cir. 1960); Mallory Assocs., Inc. v. Barving Realty Co., 90 N.E.2d 468 (N.Y. 1949). The Friedman treatise suggests that these cases in fact misapprehended applicable New York precedents. *See, e.g.*, FRIEDMAN, *supra* note 32, § 20.4, at 1292 (cases deeming security to constitute a trust are "for the most part, New York cases which were of doubtful validity" before New York's legislative landlord-tenant reform). For further background, *see* Gilbert E. Harris, *A Reveille to Lessees*, 15 S. CAL. L. REV. 412, 421-24 (1942).

A significant number of states (including New York) have now enacted statutes that explicitly obligate a landlord to hold security deposits in "trust" for its tenants' benefit. *See, e.g.*, GA. CODE ANN. § 44-7-31 (1991); N.H. REV. STAT. ANN. § 540-A:6 (1997); N.J. STAT. ANN. § 46:8-19 (Supp. 2002); N.Y. GEN. OBLIG. LAW § 7-103 (2001); S.C. CODE § 27-40-210 (McKinney Supp. 2001). Numerous other states have enacted statutes that create a similar relationship without specifically denominating the relationship as a "trust." *See, e.g.*, CONN. GEN. STAT. ANN § 47a-21 (West Supp. 2002); DEL. CODE ANN. tit. 25, § 5514(b) (Supp. 2000); MD. CODE ANN., REAL PROP. § 8-203 (Supp. 2001); MASS. GEN. LAWS ANN. ch. 186, § 15B (West Supp. 2002); N.D. CENT. CODE § 47-16-07.1 (Supp. 1997).

55. Partington v. Miller, 5 A.2d 468, 471 (N.J. Sup. Ct. 1939); Cummings v. Freehold Trust Co., 191 A. 782, 783 (N.J. 1937); Boteler v. Koulouris, 37 P.2d 136, 137 (Cal. Ct. App. 1934); *see also* Harris, *supra* note 54, at 416-21.

the landlord had no positive obligation to invest the deposit on the tenant's behalf, *any return that the landlord did earn on the deposit was considered the property of the tenant.*[56] Thus, while the pledgor could collect any interest that its pledgee earned from investing the deposit, the pledgor could not collect damages if the pledgee did not invest the deposit (i.e., interest that should have been earned).[57]

Rather than characterize the deposit as a "trust" or a "pledge," the overwhelming majority of courts resolving these landlord-tenant disputes characterized the deposit as merely a "debt." Under this view, the landlord had no duty to invest the deposit for the tenant, and the landlord could keep any interest actually earned. Title to the deposited funds passed to the landlord as soon as the tenant made the deposit. Under the "debt" characterization, the tenant retained no interest in the money at all; instead, the tenant held merely a contractual claim against the landlord for reimbursement to the extent that the tenant fully performed its lease obligations.[58] This characterization permitted the landlord to commingle the deposit with other funds and to use the deposit however it wished during the lease term, without liability to the tenant for this conduct. In adopting this characterization, courts often relied upon the fact that the typical lease placed no express contractual restraints upon the lessor's conduct with respect to handling the deposit.[59] By characterizing the deposit as a "debt," then, courts vindicated the standard commercial practices of landlords—in a fashion ostensibly consistent with the "presumed" intention of both landlord and tenant.

In recent years, of course, many state legislatures have recognized that a landlord's commingling and use of a tenant's security deposit for the landlord's own account does violate the reasonable expectations of the typical residential tenant. Further, state legislatures have also recognized that many residential tenants lack the bargaining power needed to negotiate successfully for meaningful constraints upon the landlord's handling of the deposit. As a result, many state legislatures have displaced the common law rules with statutory provisions requiring the landlord to hold a tenant's security deposit in trust for

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56. Ingram v. Pantages, 260 P. 395, 396 (Cal. Dist. Ct. App. 1927).

57. Most commentators have concluded that Section 9-207, which sets forth the rights and responsibilities of a secured party in possession of collateral, essentially codified the normal incidents of the pledgor-pledgee relationship. *See, e.g.*, 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 42.1, at 1128 (1965) (Section 9-207 reflects "evident intent of codifying the common law [regarding pledgor-pledgee relationship] without substantial change.").

58. For a summary of cases adopting this view, *see* Harris, *supra* note 54, at 413-16.

59. *See, e.g.*, Levinson v. Shapiro, 263 N.Y.S. 585, 588 (N.Y. App. Div. 1933) ("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.").

the tenant or to segregate it from other funds.[60] Some of these statutes further impose upon the landlord an affirmative obligation to pay interest on the deposit (even if the landlord did not invest the deposit so as to earn interest).[61] Absent such statutes, however, courts in landlord-tenant cases have continued to characterize the security deposit as a "debt" and have concluded that the common law places no positive obligation on landlords to pay interest on tenant security deposits.[62]

With this background in view, the court's error in *Knight* becomes apparent. As noted above, the court drew a negative inference from comparing Section 9-207, Article 2A, and other Ohio statutes applicable to lessors:

> When the General Assembly has intended to impose an obligation to pay interest on security deposits, it has done so explicitly and not in an oblique manner as the plaintiff contends was done in [Section 9-207]. Therefore, we conclude that it was not the legislative intent that lessors of automobile leases be obligated to pay the lessee interest or profits earned on the security deposits.[63]

The court assumed that if it had characterized Knight's deposit as a "pledge"—i.e., if it had ruled that Section 9-207 governed the deposit—this would have effectively reversed the common law principle that landlords had no positive obligation to pay interest on security deposits (absent express agreement). But in this assumption, the *Knight* court erroneously conflated several entirely different questions. Whether a lessor's security deposit constitutes an Article 9 security interest is an entirely separate question from

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60. *See, e.g.*, ALASKA STAT. § 34.03.070(c) (Michie 1998); COLO. REV. STAT. § 38-12-209(2)(b) (2000) (mobile home parks); CONN. GEN. STAT. ANN. § 47a-21 (West Supp. 2002); DEL. CODE ANN. tit. 25, § 5514(b) (Supp. 2000); FLA. STAT. ANN. § 83.49(1) (West Supp. 2002); GA. CODE ANN. § 44-7-31 (Harrison 1991); IOWA CODE § 562A.12(2) (2001); KAN. STAT. ANN. § 58-25,108(b) (1994) (mobile home parks); MD. CODE ANN. REAL PROP. § 8-203 (Supp. 2001); MASS. GEN. LAWS ANN. ch. 186, § 15B (West Supp. 2002); N.H. REV. STAT. ANN. § 540-A:6 (1997); N.J. STAT. ANN. § 46:8-19 (West Supp. 2002); N.M. STAT. ANN. § 47-10-10(B) (Michie 1995) (mobile home parks); N.Y. GEN. OBLIG. LAW § 7-103(3) (McKinney 2001); N.Y. REAL PROP. LAW § 233(4) (McKinney Supp. 2002) (mobile home parks); N.C. GEN. STAT. § 42-50 (1999); N.D. CENT. CODE § 47-16-07.1 (Supp. 1997); OKLA. STAT. tit. 41, § 115(A) (1999); 68 PA. CONS. STAT. § 250.511b (1994); TENN. CODE ANN. § 66-28-301(a) (Supp. 1997); WASH. REV. CODE ANN. § 59.18.270 (West 1990); WASH. REV. CODE ANN. § 59.20.170 (West Supp. 2002) (mobile home parks).

61. For a comprehensive list of these statutory provisions, *see infra* note 67.

62. *See, e.g.*, Korens v. R.W. Zukin Corp., 261 Cal. Rptr. 137, 139 (Cal. Ct. App. 1989) (refusing to create judicial rule "requiring the payment of interest on security deposits when the legislature has declined to do so").

63. Knight v. Ford Motor Credit Co., 735 N.E.2d 513, 516 (Ohio Ct. App. 2000).

whether the lessor is obligated to pay interest on that deposit or whether the lessor may commingle that deposit. Characterizing the lessor's security deposit as an Article 9 security interest (the effective equivalent of a common law "pledge") would not have reversed the common law principle that a landlord had no positive obligation to pay interest on a security deposit. A pledgee had no such positive obligation under common law, and Section 9-207 merely codified pre-Code law governing the pledgor-pledgee relationship.[64] If a court held that a lease security deposit created a pledge, such a holding thus *would impose no positive obligation on the lessor to avoid commingling the deposit with its other funds.*[65] Section 9-207, under both the 1972 text and under Revised Article 9, makes clear that a party holding a possessory security interest in money may commingle that money with other funds without violating its duties to the debtor.[66] Further, a conclusion that the lessor held a security interest in a lease security deposit *would impose no affirmative obligation on the lessor to pay interest on that deposit to the lessee.* Consistent with common law principles governing pledges, Section 9-207 does not obligate a party holding a possessory security interest in money to invest those funds in an interest-bearing account in cases where the secured party does not expressly agree to such an obligation. If a lease does not affirmatively obligate the lessor to pay interest on a security deposit, then Article 9 permits the lessor to invest the deposit in a non-interest bearing account—or to keep it in a safe or a mattress, for that matter—and to return it to the lessee at the end of the lease term without interest. By its express terms, Article 9 would compel the lessor to pay interest on the deposit to the lessee only (a) where the lease expressly provides for it, or (b) where the lessor *actually invests the deposit so as to earn "money or funds" from the deposited amount* (and even then only if the lease does not expressly disclaim any obligation to remit these sums to the lessee).

Properly understood, the issue is not whether Section 9-207 positively obligated lessors like Ford to invest the security deposits of lessees like Knight in an interest-bearing account—clearly, Section 9-207 imposes no such obligation, and thus the lessor has no such obligation unless another statute expressly imposes it.[67] Instead, the proper issue was whether Article 9 obligated

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64. 2 GILMORE, *supra* note 57, § 42.1, at 1128 (Section 9-207 reflects "evident intent of codifying the common law [regarding pledgor-pledgee relationship] without substantial change.").

65. Such a positive duty might arise due to an express statutory obligation to segregate security deposit funds—see the statutes listed *supra* note 60—but Section 9-207 would not impose such a duty.

66. U.C.C. § 9-207(2)(d) (1972) ("Unless otherwise agreed, when collateral is in the secured party's possession . . . the secured party must keep the collateral identifiable, but fungible collateral may be commingled."); U.C.C. § R9-207(b)(3) (2000) (same).

67. In the landlord-tenant context, a significant number of state legislatures have imposed upon landlords a positive duty to pay interest upon security deposits. *See, e.g.*,

Ford to remit to Knight *any return Ford did earn from his deposit*, given that Ford's lease did not expressly reserve the right to retain such sums for its own

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ARIZ. REV. STAT. ANN. § 33-1431(B) (West Supp. 2002) (mobile home landlords) (5%); CONN. GEN. STAT. ANN. § 47a-21(i) (West Supp. 2002) (average rate of insured savings institutions or 1.5%, whichever is greater); 765 ILL. COMP. STAT. § 715/1 (2001) (passbook savings rate of state's largest commercial bank on deposits held longer than six months); ME. REV. STAT. ANN. tit. 10, § 9098(2)(B) (West 1997) (mobile home landlords) (4%); MD. CODE ANN., REAL PROP. § 8-203(e) (Supp. 2002) (4%); MASS. GEN. LAWS ANN. tit. 186, § 15B (Supp. 2002) (5%, or actual interest earned if less, on deposits held one year or longer); MINN. STAT. ANN. § 504B.178(2) (West 2002) (3%, increasing to 4% after May 1, 2004); N.H. REV. STAT. ANN. § 540-A:6(IV)(a) (1997) (rate paid on savings accounts at New Hampshire banks, on deposits held one year or longer); N.J. STAT. ANN. § 46:8-19 (West Supp. 2002) (all interest earned belongs to tenant, less administrative fee; deposit must be placed in interest-bearing account); N.Y. GEN. OBLIG. LAW § 7-103 (McKinney 2001) (same); N.D. CENT. CODE § 47-16-07.1 (Supp. 1997) (all interest earned belongs to tenant where lease term is nine months or longer; deposit must be placed in interest-bearing account); OHIO REV. CODE ANN. § 5321.16(A) (Anderson 1989) (5% on deposits exceeding $50 or one month's periodic rent, where tenant remains in possession for six months or longer); 68 PA. CONS. STAT. § 250.511(b) (1994) (landlord must pay interest on deposits held for more than two years); VA. CODE ANN. § 55-248.15:1(B) (Michie Supp. 2002) (1% below discount rate, on deposits held greater than 13 months). By contrast, Florida does not obligate landlords to place deposits in interest-bearing accounts, but obligates those who do so to pay to tenants either 5% interest on deposits or 75% of the interest actually earned by deposits. FLA. STAT. ANN. § 83.49(1) (West Supp. 2002).

In a few states, legislatures have enacted general statutory landlord-tenant reforms, but those statutes expressly relieve the landlord of any obligation to pay interest on security deposits (absent a contrary lease agreement). *See, e.g.*, COLO. REV. STAT. § 38-12-209(2)(b) (2000) (mobile home landlords) (interest earned on deposit deemed property of landlord); IOWA CODE § 562A.12(2) (2001) (same); KAN. STAT. ANN. § 58-25,108(b) (1994) (mobile home landlords) (same); N.M. STAT. ANN. § 47-10-10(B) (Michie 1995) (mobile home landlords) (same); OKLA. STAT. tit. 41, § 115(B) (1999) (landlord may return deposit "without interest"); WASH. REV. CODE ANN. § 59.18.270 (West 1990) (landlord need not pay interest earned on security deposits absent contrary written agreement); WASH. REV. CODE ANN. § 59.20.170 (Supp. 2002) (mobile home landlords) (same).

In a number of states, legislation obligates landlords to place deposit funds in a bank account containing only security deposits—and to hold those funds "in trust" or "for the benefit of" the tenant—but without expressly addressing the allocation of interest earned. *See, e.g.*, ALASKA STAT. § 34.03.070(c) (Michie 1998); CAL. CIV. CODE § 1950.5(d) (West Supp. 2002); DEL. CODE ANN. tit. 25, § 5514(b) (Supp. 2000); GA. CODE ANN. § 44-7-31 (1991); HAW. REV. STAT. § 521-44(b) (1993); OR. REV. STAT. § 90.300(2) (2001); S.C. CODE § 27-40-210 (Law Co-op. Supp. 2001); TENN. CODE ANN. § 66-28-301(a) (Law Co-op. Supp. 1997). Presumably, under the existing common law rules, these statutes would obligate landlords to pay interest on security deposits if courts in those states interpreted the statutes to establish an actual trust relationship between landlord and tenant with respect to the deposit.

account. Courts can and should resolve this issue without having to express an opinion about the merits of the traditional common law rule that landlords have no positive duty to invest tenant security deposits.[68]

2. The Pledge/Debt Distinction and Article 9's Scope Provisions

The second problem with the security deposit cases is that they disregard Article 9's scope provisions. Following the adoption of Article 9, the common law's pledge/debt dichotomy as articulated in pre-Code landlord-tenant cases becomes irrelevant. Even if a security deposit creates a debt owing from the lessor to the lessee, that conclusion does not establish that the security deposit cannot also constitute an Article 9 security interest. If the lessor holds the deposit as security for the lessee's obligations under the lease, then the deposit creates both a "debt" and an Article 9 "security interest."

As a few courts appear to have conceded,[69] one cannot reconcile decisions like *Knight* and *Yeager* with the breadth of Article 9's scope provisions. While the 1972 text of Section 9-102(1)(a) stated that Article 9 governs "any transaction (regardless of its form) which *is intended* to create a security interest," this does not mean that the 1972 text required that the parties had to have contracted with specific reference to Article 9 or had to have stated "we intend to create a security interest."[70] Quite the opposite is true, as the world of

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68. As explored *infra* notes 78-81 and accompanying text, it is by no means clear that the traditional common law rule states an appropriate "gap-filler" regarding the landlord's obligation to pay interest in cases where the lease is silent.

69. *See, e.g.*, Doe v. GMAC, 635 N.W.2d 7, 10 (Wis. 2001) ("Were we writing on a clean slate, we might be receptive to [the] argument that the security deposit provision in her lease agreement with GMAC was 'intended to create a security interest' as provided [in Article 9].").

70. In its decision, the *Yeager* court looked to White and Summers' Uniform Commercial Code treatise for guidance on the appropriate legal standard for whether a contract created a security interest. Yeager v. GMAC, 719 So. 2d 210, 213 (Ala. 1998). Unfortunately, the court looked to a dated edition of the treatise, which expressed the standard as follows:

> The court must first resolve, as a question of law, whether the language embodied in the writing objectively indicates that the parties may have intended to create or provide for a security agreement. If the language crosses this objective threshold, that is, if the writing evidences a possible secured transaction and thus satisfies the statute of frauds requirement, *then the factfinder must inquire whether the parties actually intended to create a security interest.*

JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 23.3, at 905 n.5 (2d ed. 1980) (emphasis added). As explained in the text, however, this articulation confuses the nature of the inquiry. (Subsequent editions of the treatise do not contain the quoted passage.) What is important is whether the parties intended to enter into a

Article 9 is (or is supposed to be) a world of substance over form. Article 9 governs if the parties intended to enter into an agreement in which rights in property secure payment or performance of an obligation; *whether the parties intend that such an agreement should be governed by Article 9 is irrelevant.*[71] As Bill Henning, Bill Lawrence and I have explained elsewhere, "[w]ith parties sometimes disposed to disguise the true nature of their transactions, courts cannot accept their expressions of intention as controlling and simply pursue [the parties'] underlying subjective intentions to ascertain the appropriate legal characterization of any given transaction."[72] The appropriate inquiry is whether the parties entered into a transaction in which they used property to secure payment or performance of an obligation—if so, then Article 9 applies regardless of the parties' subjective intentions, unless Article 9 expressly excludes that transaction from its scope.

Both the text of Article 9 and its comments plainly contemplate that parties can create a security interest in money.[73] This dictates a conclusion that if one party requires another party to deposit money in order to secure the depositor's payment or performance obligations to the depositee, then a security interest in

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contractual relationship in which rights in property serve to secure payment or performance of an obligation—not whether the parties intended that this agreement would constitute a "security agreement." WILLIAM H. LAWRENCE, WILLIAM H. HENNING & R. WILSON FREYERMUTH, UNDERSTANDING SECURED TRANSACTIONS § 2.02[A], at 76-78 (2d ed. 1999).

Revised Article 9 avoids the potential confusion created by the word "intended" by defining its basic scope in terms of "a transaction, regardless of its form, *that creates* a security interest in personal property." U.C.C. § R9-109(a)(1) (2000). The comments make clear that this understanding should have been implicit under the 1972 text of Section 9-102 cmt. 2, and this understanding is consistent with Professor Gilmore's observation that "intended" in this context "has nothing to do with the subjective intention of the parties, or either of them." 1 GILMORE, *supra* note 57, at § 11.2, at 338.

71. U.C.C. § R9-109, cmt. 2 ("When a security interest is created, this Article applies regardless of the form of the transaction or the name that parties have given to it.").

72. LAWRENCE ET AL., *supra* note 70, § 1.03[A], at 12. Section 1-201(37)'s definition of "security interest" makes this explicit in authorizing courts to re-characterize as a "security interest," in appropriate cases, a transaction that the parties themselves labeled as a "lease." U.C.C. § 1-201(37) (1999).

73. U.C.C. § R9-313(a) (2000) ("a secured party may perfect a security interest in . . . money . . . by taking possession of the collateral"); *id.* § R9-332(a) ("A transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party."); *id.* § R9-313 cmt. 2 ("[Section R9-313] permits a security interest to be perfected by the taking of possession only when the collateral is goods, instruments, negotiable documents, money, or tangible chattel paper"); *id.* § R9-310 cmt. 2 (filing ordinarily [does not] perfect a security interest in . . . money"); *id.* § R9-315 cmt. 2 ("Section 9-332 enables . . . most transferees of money to take free of a perfected security interest in the . . . money.").

money arises—unless Article 9's scope provisions explicitly exclude that transaction. Notably, Article 9's scope provisions contain *no express exclusion* for security deposits.[74] Furthermore, a "security deposit" serves the exact same economic function as a possessory security interest in money. Thus, if the cases excluding lease security deposits from the scope of Article 9 are correct, then any parties using money to secure payment or performance of an obligation can opt out of Article 9 altogether merely by calling the transfer a "security deposit." As a result, excluding security deposits from the scope of Article 9 would render superfluous those provisions that contemplate the existence of possessory security interests in money.

Further, Section 303 of the new Uniform Consumer Leases Act ("UCLA"), which governs security deposits in consumer leases, strongly reinforces the conclusion that a security deposit is an Article 9 security interest. Section 303(a) provides that "[e]xcept as otherwise provided in subsection (b), a consumer lease . . . may not provide for the creation of a security interest in personal or real property of the lessee to secure the payment of obligations arising from the lease."[75] Section 303(b) then provides that a consumer lease "may provide for . . . a security deposit."[76] By treating security deposits as a subset of the broader term "security interest"—and allowing them as an exception to its general prohibition against the lessor's taking of security—the UCLA implicitly recognizes that a security deposit in a consumer lease is an Article 9 security interest in money.[77]

In sum, to justify the rationale of the security deposit cases, one would have to indulge the assumption that the drafters intended that a possessory security interest in money would arise only in transactions where the parties were too stupid or uninformed to use the term "security deposit" to describe their agreement. Given Article 9's generally expansive scope provisions and its warning that courts should interpret them by reference to economic substance rather than legal form, courts are simply wrong to conclude that Article 9 excludes security deposits. With respect to its scope, Article 9 is not a baseline rule from which parties are free to opt out by contract, and courts most certainly should not interpret Article 9's scope provisions to make it so.

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74. U.C.C. § 9-104 (1972); U.C.C. § R9-109(d) (2000).

75. U.C.L.A. § 303(a) (2002). The UCLA defines the term "security interest" to have the identical meaning as the same term under the UCC. *Id.* § 102(b)(9).

76. *Id.* § 303(b)(1).

77. Uniform Consumer Credit Code (UCCC) Section 3.301(2) provides a comparable provision and thus gives rise to a comparable inference. Likewise, substantially comparable provisions already exist in a number of states that have adopted provisions based upon the UCCC. *See, e.g.*, 815 ILL. COMP. STAT. § 636/30 (1999); IOWA CODE § 537.3301(2) (2001); S.C. CODE ANN. § 37-2-407(2) (Law. Co-op. 2002); WIS. STAT. ANN. § 422.417(2) (West Supp. 2001); WYO. STAT. ANN. § 40-14-241(b) (Michie 2001).

3. Is "No Interest on Security Deposits" an Appropriate Baseline Rule?

The reasoning of the security deposit cases has also had one potentially unfortunate side-effect: courts in the security deposit cases have simply taken for granted that the traditional common law rule (i.e., no interest on a security deposit where the lease is silent) provides an appropriate baseline rule. But it is not entirely clear that the traditional common law rule states an appropriate "gap-filler." Presumably, the argument in support of the traditional rule is that in any particular lease, the lessor's costs of investment, recordkeeping, and reimbursement might exceed the interest actually earned on the deposit. Certainly, no lessor would voluntarily agree to reimburse its lessee \$6 in earned interest if the lessor would incur more than \$6 in administrative costs—at least not without the lessee's agreement to pay an additional amount in rent to compensate the lessor for this administrative expense. Moreover, if the administrative expense exceeded the expected interest, the lessee would presumably forgo any claim to interest earned rather than bear the higher rent that the lessor would demand to pay such a duty. Thus, in looking at any isolated lessor-lessee bargain, it seems reasonable to predict that reasonable parties would agree that the lessor should have no obligation to pay interest on the lessee's security deposit. Under this analysis, a "no interest on security deposits" rule appears to make sense as a gap-filler.[78]

There are two problems with this argument, however. First, while the argument is sensible in the context of an individual lessor-lessee negotiation, it may break down in the context of multiple transactions. For the first lessee, the lessor's administrative costs may well exceed the interest payable to that lessee. But as a commercial lessor deals with increasing numbers of lessees, economies of scale reduce the lessor's administrative costs on a per-lessee basis. The lessor's total costs may in fact be less—perhaps quite a bit less—than the total interest that the lessor could accrue on all aggregated security deposits. In this context, if individual lessees could organize and bargain collectively, a reasonable lessor might be compelled to agree to pay interest on security deposits (or capitulate to organized lessee demands for rent concessions to offset the forgone interest). That assumes, however, that no structural barriers to such a voluntary agreement exist. In reality, lessees negotiate leases individually, not collectively, and no individual lessee has a sufficient financial incentive to negotiate for and obtain the lessor's general commitment to pay interest on all lessee security deposits. As a result, lessees can only bargain collectively in an indirect fashion—through legislatures—where the structural barrier to collective bargaining is more easily overcome. By enacting legislation obligating lessors to pay interest on security deposits, the legislature may be seen as bargaining on

78. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 91-93 (4th ed. 1992) (discussing use of economic analysis in filling contractual gaps).

behalf of diffuse lessees, accomplishing the bargain that unimpeded collective bargaining presumptively would have produced.[79]

The second problem is that the traditional argument assumes equality of bargaining power between lessors and lessees—an assumption many would reject as false, at least in the contexts of residential leases of land and consumer leases. Certainly, the lessor benefits from the use of the lessee's money during the lease term, even if that benefit is less than the administrative cost of accounting for it. Thus, under the traditional argument, one might expect that market forces would compel the lessor to accept a slight rent concession in order to avoid the administrative costs of accounting for interest on lessee security deposits. But to the extent that residential lessors have systematically greater bargaining power than lessees, lessors may instead refuse to make any rental concession and pocket this benefit for themselves—thus explaining why many legislatures have chosen to make deposit protection regulations nonwaivable.[80]

With these insights, one might take two distinct views of state legislation requiring lessors to pay interest on tenant security deposits. One might view such legislation as a policy-driven rejection of contrary common law principles, driven by real or perceived bargaining power inequalities and implemented in order to constrain rent-seeking behavior by lessors. Under this view, a court in a state without such a statute would presumably continue to conclude that lessors should have no positive duty to pay interest on lessees' security deposits. Alternatively, one might treat such statutes as a recognition of the hypothetical lessor-lessee bargain absent structural barriers to collective negotiation. Under this latter view, courts in states without a statute might well conclude that evolving common law principles should place a positive duty upon landlords to pay interest on security deposits, absent an express contrary agreement between the parties. Unfortunately, by uncritically accepting the common law no-interest-on-security-deposits rule, the security deposit cases have not explored these alternative views at all—which is somewhat surprising, given the significant influence that economic analysis of law has had in transforming the landlord-tenant relationship generally.[81]

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79. *See, e.g.*, 765 ILL. COMP. STAT. § 715/1 (2001) (landlord with 25 or more units obligated to pay interest on deposits held more than six months); N.J. STAT. ANN. § 46:8-19 (West Supp. 2002) (landlord with ten or more units obligated to pay interest on deposits); N.Y. GEN. OBLIG. LAW § 7-103 (McKinney 2001) (landlord with six or more units obligated to pay interest on deposits).

80. *See, e.g.*, CONN. GEN. STAT. ANN. § 47a-4(a)(4) (Supp. 2002) (lease cannot disclaim landlord's obligation to pay interest on deposit); MD. CODE ANN., REAL PROP. § 8-203(i) (Supp. 2001) (same); N.H. REV. STAT. ANN. § 540-A:8(III) (1997) (same).

81. For example, in recent years, courts have shown a willingness to use contract law principles, where appropriate, to imply into leases obligations going beyond those traditionally imposed by landlord-tenant law. *See, e.g.*, Pugh v. Holmes, 405 A.2d 897 (Pa. 1979) (adopting implied warranty of habitability); Schneiker v. Gordon, 732 P.2d

C. Rethinking the Auto Lease Security Deposit Dilemma

Like many Article 9 teachers, I sometimes struggle to help intimidated students see and appreciate Article 9's general coherence. As a result, the most exasperating thing about the security deposit cases is that *there was no need for the courts to have reached the sweeping conclusion that Article 9 excluded security deposits.* In each case, the court could have decided the case on the merits, in favor of the lessor, without concluding that a security deposit was not an Article 9 security interest.

To see why, consider the facts of the typical automobile lease transaction which has given rise to most of the disputes. Lessee Jane enters an auto lease. Jane pays Dealer a $250 security deposit pursuant to the lease, which is silent regarding Lessor's obligation to invest (or pay interest upon) the deposit. Dealer then assigns the lease to Manufacturer Credit Company ("MCC"), the financing arm of the auto manufacturer. Rather than negotiating the deposit check to MCC, Dealer simply agrees that MCC will deduct $250 (the deposit amount) from the sum it has agreed to pay Dealer to purchase the lease. Thus, MCC never physically receives Jane's money; instead, it merely maintains on its books an account payable to Jane at the conclusion of the lease term. Dealer, having assigned the lease to MCC (and the expected liability for return of the deposit), then places the deposit check in its own operating account, and shortly thereafter spends it on the typical expenses associated with running an automobile dealership. When the lease term expires, MCC satisfies the account payable by issuing a check for the deposit amount (without interest) to Jane.

In this hypothetical, nothing in Section 9-207 would justify judgment for Jane if Jane sued to collect interest on her security deposit. Section 9-207 does not impose upon the secured party any affirmative obligation to invest money held as collateral on the debtor's account. Because neither Dealer nor MCC invested Jane's deposit in an interest-bearing account,[82] neither received "money

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603 (Colo. 1987) (obligating landlord to mitigate loss caused by tenant's abandonment of premises). *See generally* Charles J. Goetz, *Wherefore the Landlord-Tenant Law "Revolution"?—Some Comments*, 69 CORNELL L. REV. 592 (1984).

82. MCC might also argue that because it did not actually receive Jane's deposit check (but merely credited the amount of the deposit against the purchase price of the lease), it never took possession of the deposit within the meaning of Article 9. If this were true, of course, MCC would not have the duties imposed upon a secured party holding a possessory security interest under Section 9-207. At least one court has relied upon this argument in rendering judgment for the lessor. *See* Knight v. Ford Motor Credit Co., 735 N.E.2d 513, 518 (Ohio Ct. App. 2000) ("We are not persuaded that listing a security deposit as an increase to a security deposit payable account is the same as a 'sum in [Ford Credit's] possession.' . . . An account payable entry on a balance sheet by no means implies physical possession of the account to be paid.").

This argument is too cute by at least half. By virtue of deducting the deposit from or funds" from the deposit within the meaning of Section 9-207.[83] Thus, because the lease did not obligate Lessor to pay interest upon the deposit, neither Dealer nor MCC would have liability to Jane for interest upon that sum under Article 9.[84]

In an attempt to avoid this result, Jane might argue that MCC did in fact benefit from the deposit, because it reduced MCC's cost of acquiring the lease by $250 and thereby enabled MCC to obtain indirect but potentially quantifiable financial benefits. For example, assume that each month, MCC purchased noninterest-bearing certificates of deposit from the banks who handle MCC's financial services, in an amount equal to the total amount of security deposits under leases purchased during that month. Even if MCC did not earn interest on these certificates, MCC might still benefit economically in significant ways. These available funds might reduce MCC's need to borrow (thereby saving interest costs on money not borrowed) or enable MCC to earn a return by investing its excess funds in otherwise productive investments (such as purchasing more automobile leases).[85] Alternatively, MCC's banks might provide MCC with "earnings credits" on these deposits which might offset banking fees for which MCC would otherwise be liable.[86] But if Jane argues that these indirect benefits constitute "money or funds received from" the deposit within the meaning of Article 9, courts properly should reject this argument. First, under such an argument, Section 9-207 would no longer serve merely to codify pre-Code common law principles regarding pledges.[87] By imposing

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the lease purchase price, MCC unquestionably has dominion over a sum of money equal to the amount of the original deposit. Because money is fungible, it should be irrelevant that this sum is not the exact same $250 that Jane originally paid. Properly understood, MCC clearly has possession of a sum equivalent to the amount of the security deposit. Of course, as explained in the text, MCC's mere possession of the $250 does not impose upon MCC any obligation to invest that sum for Jane's benefit.

83. Martin v. Gold Key Lease, Inc., 988 F. Supp. 1101, 1104-05 (N.D. Ill. 1997); Demitropoulos v. Bank One Milwaukee, N.A., 953 F. Supp. 974, 984-87 (N.D. Ill. 1997); *Knight*, 735 N.E.2d at 518-20.

84. This reasoning could have sustained a judgment in favor of the lessor in *Dolan v. GMAC*, 739 N.E.2d 848 (Ohio Ct. App. 2000), but the *Dolan* court never addressed or even acknowledged such a possibility. In *Doe v. GMAC*, 635 N.W.2d 7 (Wis. Ct. App. 2001), the court acknowledged this possibility, but refused to address it based upon the court's broader conclusion that Article 9 excluded lease security deposits. *Doe*, 635 N.W.2d at 12. By contrast, in *Knight*, the court relied upon this argument as an alternative basis for its decision. *Knight*, 735 N.E.2d at 518-20.

85. The plaintiffs unsuccessfully made such an argument in the *Demitropoulos* and *Knight* cases. *Demitropoulos*, 953 F. Supp. at 984-85; *Knight*, 735 N.E.2d at 518-19.

86. The plaintiffs unsuccessfully raised such an argument in In re *Ford Motor Credit Co. Motor Vehicle Lease Litig.*, No. 95 CIV. 1876, 1998 WL 159051, at **1-3 (S.D.N.Y. Apr. 1, 1988).

87. *See supra* note 64.

liability for indirect benefits associated with mere possession of the money, it would effectively force the secured party to invest the collateral in order to offset this liability—thereby unquestionably triggering the applicability of Section 9-207.[88] Second, such an argument creates severe practical tracing problems. In the MCC hypothetical, it is unclear whether or how a court could accurately quantify the financial benefits to MCC associated with a combination of reduced borrowing costs and earning credits.[89] Moreover, given that MCC's borrowing needs would undoubtedly fluctuate over time, it is unclear how MCC could accurately allocate the benefit associated with reduced borrowing costs to lessee's particular lease (as distinguished from other leases acquired at different times).

Thus, to the extent that MCC's practices for handling security deposits are similar to those prevailing within the industry, MCC would not incur liability to

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88. *See, e.g.*, *Demitropoulos*, 953 F. Supp. at 985 ("If [this interpretation of Section 9-207 were] adopted, courts would have license to hold lessors who place security deposits in non-interest-bearing bank accounts liable to lessees for any hypothetical benefits the account might generate, such as an enhanced credit line from the bank.").

89. *Id.* ("This Court will not, without legislative direction, place on lessors such an onerous burden to discern and calculate every possible benefit, no matter how small or tangential, gained from holding onto a security deposit. The UCC was enacted to 'simplify, clarify and modernize the law governing commercial transactions,' not complicate and muddle it.") (quoting U.C.C. § 9-102(2)(a) (1972)).

In other contexts, Article 9's drafters have scrupulously avoided creating rights or responsibilities that would produce similar practical tracing burdens. For example, consider Article 9's treatment of the secured party's interest in proceeds of its collateral. Article 9 defines proceeds to include "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral," U.C.C. § R9-102(a)(64)(A) (2000), as well as "whatever is collected on, or distributed on account of, collateral," U.C.C. § R9-102(a)(64)(B) (2000). Such a broad definition might well create significant tracing problems. For example, suppose that Bank finances Contractor's purchase of a bulldozer and takes a security interest in the bulldozer. Contractor then uses the bulldozer on a series of jobs that produce accounts receivable. Under the Code's broad definition of "proceeds," one might argue that the accounts constitute proceeds of the bulldozer. *See, e.g.*, R. Wilson Freyermuth, *Rethinking Proceeds: The History, Misinterpretation and Revision of Section 9-306*, 69 TULANE L. REV. 645, 699-707 (1995) (noting that accounts generated through use of depreciating collateral such as equipment are functionally comparable to sums generated through the lease of depreciating collateral, and arguing that each are properly understood as "proceeds" of the collateral). Of course, the accounts are not attributable solely to the bulldozer, but also to Contractor's labor, experience, and expertise (and perhaps to other consumable inputs)—and these latter items are not subject to Bank's security interest. Recognizing that the resolution of such tracing problems would be practically impossible, Article 9's drafters made clear that the secured party's interest continued only as to "identifiable" proceeds. U.C.C. § 9-306(2) (1972); U.C.C. § R9-315(a)(2) (2000). This limitation effectively moots any argument that Bank gets proceeds coverage over Contractor's accounts.

pay interest on lease security deposits. Absent either a contrary agreement in the lease itself or contrary positive law (i.e., a statute other than Article 9), Article 9 would create such liability *only* in the rare case where MCC actually invested the deposit in an interest-bearing account. Furthermore, MCC can easily avoid such liability by ensuring that the lease expressly allocates any interest or return earned on the deposit to the lessor/assignee. As Section 9-207 establishes merely a baseline rule, such an express contractual provision would be enforceable (unless law other than Article 9 affirmatively and immutably obligated the lessor to pay interest).

Likewise, to the extent that MCC's practices for handling security deposits are similar to those prevailing within the industry, MCC would not incur liability on account of its commingling and handling of security deposit funds. Section 9-207 makes clear that the secured party may commingle fungible collateral (such as money) as long as the secured party keeps the collateral identifiable.[90] Thus, Article 9 would not force MCC to segregate the security deposits from other company funds. Further, as long as MCC eventually refunded security deposits to its lessees, Section 9-207's identifiability requirement would not pose any meaningful liability risk to MCC. At first blush, the obligation to keep the collateral identifiable would appear to prevent MCC from disposing of security deposit funds for its own purposes, at least if at the time of disposition MCC lacked other unencumbered funds in an amount sufficient to satisfy its security deposit obligations. But even if such use of the funds violates Section 9-207, MCC would face no liability for this violation as long as it eventually refunded the deposit in a timely fashion—because MCC's lessees would suffer no actual loss on account of MCC's behavior, and none of Article 9's consumer penalties would apply in this instance.[91]

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90. U.C.C. § 9-207(2)(d) (1972); U.C.C. § R9-207(b)(3) (2000).

91. Ordinarily, the secured party is liable only for actual damages caused as a result of its failure to comply with its Article 9 obligations. U.C.C. § 9-507(1) (1972); U.C.C. § R9-625(b) (2000). Article 9 does provide for minimum damages, regardless of loss, if the collateral is consumer goods. U.C.C. § 9-507(1) (1972); U.C.C. § R9-625(c) (2000) ("an amount not less than the credit service charge plus 10 percent of the principal amount of the obligation or the time-price differential plus 10 percent of the cash price"). This "consumer penalty" would not apply in the security deposit cases, however, because the collateral would be "money" and Article 9 expressly dictates that "consumer goods" does not include money. U.C.C. § 9-105(1)(h) (1972); U.C.C. § R9-102(a)(44) (2000) ("goods" does not include money). Further, while Revised Article 9 does provide for statutory damages (regardless of actual loss) in the event of secured party noncompliance with certain provisions, *see* U.C.C. § R9-625(e),(f) (2000), these provisions do not include Section 9-207. Thus, absent contrary lease provisions, MCC would face liability for its conduct in handling security deposits only in cases where MCC actually failed to refund the security deposit in a timely fashion.

Thus, even if courts properly treated security deposits as Article 9 security interests, most existing lease transactions should not render lessors and/or assignees liable for interest on security deposits. Further, lessors and their assignees could quickly adjust to avoid even the minimal risk of liability in future transactions. As a result, there is no functional reason for courts to interpret Article 9 so as to exclude lease security deposits from its scope.[92] In his work on the interpretive challenges presented by drafting errors within Article 9,[93] Professor Gregory Maggs articulated five general guidelines for courts in interpreting Article 9's provisions: (1) courts should generally interpret the Code in accordance with its purposes, as dictated by Section 1-102(1);[94] (2) courts should establish a presumption of codification, not revision;[95] (3) courts should recognize that the Code establishes mostly baseline rules;[96] (4) courts should appreciate the need for uniformity;[97] and (5) courts should adopt inclusive approaches to scope questions.[98] Consideration of these guidelines confirms the lack of any functional justification for courts to interpret Article 9 as excluding security deposits.

In the context of the security deposit cases, guidelines (1) and (5) most clearly suggest treating lease security deposits as Article 9 security interests. There can be no doubt that Article 9's primary purpose was to consolidate the mélange of pre-Code security devices within the unitary conception of the

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92. Treating the security deposit as a security interest in money would have no practical consequences for the lessor's enforcement of its rights. While Article 9 requires the secured party to dispose of collateral after default in a "commercially reasonable" fashion, U.C.C. § 9-504(3) (1972); U.C.C. § R9-610(b) (2000), the secured party would "dispose" of money collateral simply by applying it to the debt. Accordingly, the "reasonableness" of any such disposition would focus solely upon the lessor's mathematical calculation of the debt. Further, the lessor would not have to provide notification to the lessee or other parties prior to enforcement (unless the lease agreement provided to the contrary), as money is customarily exchanged in a recognized market and Article 9 excuses notice in such circumstances. U.C.C. § 9-504(3) (1972); U.C.C. § R9-611(d) (2000).

93. Gregory E. Maggs, *Patterns of Drafting Errors in the Uniform Commercial Code and How Courts Should Respond to Them*, 2002 U. ILL. L. REV. 81.

94. *Id.* at 117 (Section 1-102(1) directs that the Code "shall be liberally construed and applied to promote its underlying purposes and policies.").

95. *Id.* at 118 ("Unless something indicates otherwise, courts should presume the drafters intended only to preserve the previous rule.").

96. *See infra* text accompanying note 104.

97. Maggs, *supra* note 93, at 119 ("Although courts do not have to follow UCC precedents from other jurisdictions, they often should do that. Nonuniformity among jurisdictions may hinder the planning of interstate commercial transactions and increase the cost of resolving disputes.").

98. Maggs, *supra* note 93, at 119.

"security interest."[99] Furthermore, the Code establishes a clear directive that courts should resolve scope-related issues by reference to economic substance rather than legal form or location of title.[100] This is most clearly demonstrated in Section 1-201(37), which prevents parties from entering into a security transaction and avoiding the consequences of Article 9 merely by characterizing their agreement as a "lease" governed by the common law of leasing.[101] Likewise, courts should not permit the parties to "opt out" of Article 9's scope altogether merely by characterizing a security device as a "deposit."

Properly understood, guideline (2)—the presumption of codification—does not justify excluding lease security deposits from Article 9 security interests. Courts in the security deposit cases (as in *Knight*) have concluded that because pre-Code common law clearly established that lessors had no duty to pay interest on security deposits, the drafters should be assumed to have effectively codified that rule. But as explained above,[102] such a conclusion is a non sequitur. Section 9-207 does not establish a baseline rule positively obligating the secured party to pay interest on money collateral held in its possession. Section 9-207 instead codifies pre-Code rules governing pledges, under which the pledgee had no duty to invest the collateral on the pledgor's behalf, but did have to account for the earnings if it did invest the collateral. In the security deposit cases, courts have misinterpreted the fact that Section 9-207 does not impose a positive obligation to pay interest. The courts have not treated this as a mere codification of pre-Code pledge law, *but as evidence that Article 9's scope provision implicitly accepted landlord-tenant law's distinction between a "pledge" and a "debt."* This is simply bizarre; Section 9-207 is not a scope provision, and there is no evidence that the drafters viewed it as being relevant to the resolution of scope issues. As to Article 9's scope, it is Section 1-201(37) that is critical, and the language of that Section thoroughly belies any conclusion that Article 9's drafters blindly accepted formal distinctions grounded in landlord-tenant law.[103]

Likewise, guideline (3)—that the Code establishes principally baseline rules—does not justify excluding lease security deposits from Article 9's scope. As Professor Maggs has explained this guideline:

99. *See, e.g.*, U.C.C. § 9-101 cmt. (1972); § R9-101 cmt. 1 (2000); 1 GILMORE, *supra* note 57, § 9.1, at 288-90 (1965).

100. U.C.C. § 9-202 cmt. (1972); § R9-202 cmt. 2 (2000) (location of title irrelevant with respect to rights and responsibilities of parties to a secured transaction).

101. *See* U.C.C. § 1-201 cmt. 37 (1999) (scope of "security interest" to be informed by "economics" rather than parties' subjective intent as manifested by formal labels).

102. *See supra* notes 64-68 and accompanying text.

103. *See supra* note 70 and accompanying text.

> The ability of parties to contract around most of the rules in the UCC should give courts some comfort when confronting gaps, conflicts, and ambiguities in the UCC. No matter what choices they make, their decisions may have only a limited effect on future cases. If parties in the future want a different rule, they generally can establish one in their contracts. With this idea in mind, courts often should have two goals when selecting the meaning of a UCC provision that they otherwise cannot interpret. First, courts should select the rule that most parties in the future will favor to save them the effort of having to contract around it. Second, courts should make clear what choice they have made so that parties in the future may revise the rule by agreement if they choose.[104]

One might argue, as the court appears to have done in *Knight*, that excluding security deposits from Article 9 is appropriate because historical practice proves that lessors will not agree to pay interest on security deposits unless forced to do so by legislation.[105] Thus, excluding security deposits from Article 9 would save the parties from having to express this understanding explicitly or having to bargain around a contrary result. By the same token, however, it hardly seems burdensome to obligate lessors—who overwhelmingly tend to be the masters of their own documents—to make such an understanding implicit in their forms. This seems particularly appropriate to the extent that historical landlord practice (particularly in the residential context) reflects more about bargaining power inequalities than the underlying shared understandings of the parties.[106] Moreover, excluding lease security deposits from Article 9 in order to validate this historical practice presents a more compelling problem—*Article 9's scope provision is not a baseline rule*. The lease security deposit cases allow the lessor to escape the impact of Article 9 merely by denominating the payment as a "deposit," but nothing in Article 9 appears to sanction such a practice.

Only guideline (4)—facilitation of uniformity—could plausibly justify a court's adherence to the view that Article 9 excludes lease security deposits from its coverage. As Professor Maggs argues, interjurisdictional nonuniformity might so increase the cost of planning transactions and resolving disputes as to justify a state court in following what it believes to be another state court's earlier yet erroneous interpretation of the Code.[107] In its decision in *Doe*, the Wisconsin Court of Appeals appears to have rested its conclusion on this very ground—relying upon the conclusions of earlier decisions in other states despite overt doubt about whether that result could be squared with the language of

104. Maggs, *supra* note 93, at 118.

105. *See supra* note 34 and accompanying text.

106. *See supra* text accompanying note 80.

107. Maggs, *supra* note 93, at 119.

Article 9.[108] Nevertheless, there is a countervailing argument: interjurisdictional nonuniformity may both crystallize disputed issues for further debate (and better, more informed decisionmaking) and provide useful empirical data about the economic impact of different decision rules.[109] Further, because of the unique role of the UCC and its Permanent Editorial Board ("PEB")—which can issue targeted interpretive commentary when interpretive questions or problems arise[110]—interjurisdictional nonuniformity does not necessarily require the extensive costs of statutory amendment and fifty-state recodification. As has happened on other occasions, the PEB may issue commentary on the appropriate resolution of scope issues,[111] and courts have generally accorded PEB Commentaries significant weight as authoritative interpretive guides.[112] Thus,

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108. Doe v. General Motors Acceptance Corp., 635 N.W.2d 7, 10 (Wis. Ct. App. 2001) ("Were we writing on a clean slate, we might be receptive to Doe's argument that the security deposit provision in her lease agreement with GMAC was 'intended to create a security interest' as provided in [Section 9-102(1)(a)]. The issue of UCC Article Nine's applicability to this transaction is far from one of first impression, however. Although no Wisconsin appellate court has considered the issue, courts in several other jurisdictions which have enacted the UCC have done so. We may properly look to these rulings from other jurisdictions to guide our analysis of [Wisconsin's version of Section 9-207], so as to further the goal of uniformity of interpretation of the provisions of the UCC.").

109. This is to some extent analogous with the view that circuit splits within the federal courts are desirable because they produce "percolation" of issues and thus produce better eventual decisions in the long run. *See, e.g.*, Charles L. Black, Jr., *The National Court of Appeals: An Unwise Proposal*, 83 YALE L.J. 883, 898 (1974) (arguing that many conflicts "perhaps ought to be endured while judges and scholars observe the respective workings out in practice of the conflicting rules"); *see also* Michael Abramowicz, *En Banc Revisited*, 100 COLUM. L. REV. 1600, 1638-40 (2000) (discussing impact of alternative proposals for en banc review of appellate decisions in light of ostensible percolation and experimentation benefits associated with interjurisdictional nonuniformity).

110. The PEB issues commentary from time to time for one or more of the following purposes: (1) to resolve an ambiguity by articulating the PEB's view of the correct legal rule; (2) to express the PEB's preferred view on an issue where court opinions or scholarly commentary disagree; (3) to elaborate on the Code's application where the statutory language or comments leave doubt as to the Code's scope; (4) to apply Code principles to new or changed circumstances; (5) to clarify the relationship between the Code, other statutes, and general principles of law and equity; or (6) to otherwise improve the operation of the Code. *See* PREFACE TO PEB COMMENTARY, PEB RESOLUTION ON PURPOSES, STANDARDS AND PROCEDURES FOR PEB COMMENTARY TO THE UCC (March 14, 1987).

111. *See* PEB Commentary No. 12 (Section 9-302) (February 10, 1994); PEB Commentary No. 14 (Section 9-102(1)(b)) (June 10, 1994).

112. *In re* Kelaidis, 276 B.R. 266, 270 (B.A.P. 10th Cir. 2002); Phillips v. Ball and Hunt Enters., Inc., 933 F. Supp. 1290, 1295 n.12 (W.D. Va. 1996); *In re* Solfanelli, 206

even the functional goal of promoting uniformity does not clearly justify decisions exempting lease security deposits from Article 9's scope.

II. WHO CARES? WHY THE SECURITY DEPOSIT CASES MATTER

At this point, it is fair to ask whether Part I is much ado about nothing. Section 9-207 expresses a baseline rule around which parties are free to bargain. Thus, even if courts interpreted Article 9 correctly in the security deposit cases, one might expect lessors to adjust by amending their lease forms to disclaim any obligation to invest a security deposit for the lessee's benefit and/or to allocate any investment return to the lessor. Further, the newly promulgated Uniform Consumer Leases Act ("UCLA") would establish a baseline rule that the lessor in a consumer lease has no positive obligation to pay interest on a security deposit.[113] If adopted by a jurisdiction, the UCLA would clearly displace Article 9's more general rules regarding interest on security deposits under consumer leases. Thus, in the big picture, *does it really matter* how the courts have decided these cases?

There are at least a couple of reasons to answer "maybe." First, there are millions of consumer lease transactions, both with respect to land[114] and personalty, and these transactions commonly include security deposits. Not all

B.R. 699, 711 (Bankr. M.D. Pa. 1996); Florida E. Coast Prop., Inc. v. Best Contract Furnishings, Inc., 593 So. 2d 560, 562 (Fla. App. 1992); Am. Fed. Sav. & Loan Ass'n v. Madison Valley Prop., Inc., 958 P.2d 57, 67 (Mont. 1998); Huffman v. Altec Int'l, Inc., 546 N.W.2d 162, 165-68 (Wis. 1996).

113. UCLA § 303(d) (2002).

114. The analysis in Part I would apply to a security deposit in a residential lease to the same extent as a similar deposit in an automobile lease—and accordingly security deposits in residential leases should also fall within Article 9's scope absent an express legislative pre-emption. A few cases have concluded that even if a security deposit generally constitutes a security interest under Article 9, a security deposit in a lease of land would not—ostensibly because Section 9-104(j) of the 1972 text (and revised Section R9-109(d)(11)) exclude from Article 9's coverage "the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder." *See, e.g.*, Demitropoulos v. Bank One Milwaukee, N.A., 953 F. Supp. 974, 981 (N.D. Ill. 1997) ("[R]eal property lease deposits are encompassed by § 9-104(j)'s exclusion, while the automobile lease deposit in this case is not."). Such a conclusion, however, is plainly wrong. This provision only excludes security interests or liens in real estate—in other words, a mortgage on land, or a security interest in a lease itself. It would not exclude any security interest otherwise covered by Article 9 merely because that interest was created within a lease. For example, if a landlord required its tenant to sign a lease in which the landlord took a security interest in all of the tenant's assets in order to secure the tenant's rental obligations, that security interest is plainly governed by Article 9. Because the tenant's security deposit is a security interest in money, not land, it would not be subject to the Article 9 "land" exclusion.

jurisdictions will adopt the UCLA or comparable statutes, not all state landlord-tenant statutes are clear about allocation of interest earned on security deposits,[115] and some contracting parties will continue to fail to express their intentions with sufficient clarity to resolve questions about such allocations. As a result, there will continue to be some number of disputes—and the very existence of contract law suggests some threshold public interest in how these disputes are resolved. In this regard, one notable characteristic of the security deposit cases is that they reflect an uncritical acceptance of the common law no-interest-on-security-deposits rule as an appropriate baseline rule under contract law. But as suggested previously,[116] one can argue that in transactions where the lessor is contemporaneously engaged in large numbers of similar consumer transactions—such as in cases involving the financing of automobile leases or the leasing of residential land by developers with significant inventory—"no interest on security deposits" may not accurately reflect the predicted arms-length hypothetical bargain. In recognition of this fact, legislation in many states has compelled certain lessors to pay interest on security deposits. As such, one might argue that courts properly can and should reconsider whether evolving commercial common law should continue to adhere to a no-interest-on-security-deposits default rule (at least in cases where the lessor holds multiple deposits).[117]

Second, although the answer to the question "Why have courts so egregiously misinterpreted Article 9?" may not be clear, the answer may be quite relevant depending upon what that answer is. One possible answer is that despite the drafters' best efforts at producing coherence in the drafting of Article 9, some courts "just don't get it." There are no systematic empirical studies of the "accuracy" of decisions in Article 9 cases, but all of us who teach Article 9 have often read an opinion and ended up shaking our heads in disbelief, mystified as to how the court possibly could have screwed up so badly.[118] Many

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115. *See supra* note 67.

116. *See supra* notes 78-81 and accompanying text.

117. *See supra* notes 74-81 and accompanying text. I do not suggest that such a reconsideration should necessarily result in rejecting the traditional no-interest-on-security-deposits default rule. The difficulties associated with drawing lines circumscribing those in the "business" of leasing may well justify a conclusion that rejection of the default rule should occur only through legislative action. But the question at least seems worthy of further exploration.

118. Sadly for teachers, the Article 9 revisions overruled most of our favorites, somewhat mooting their usefulness as teaching vehicles. We should not fear, though; undoubtedly, some judges will prove just as "up to the task" of misinterpreting revised Article 9. For example, the Eleventh Circuit recently held that under Florida law, title to collateral passed to the secured party upon repossession—prior to sale—and that nothing in Florida's version of Article 9 conflicted with this conclusion. Really, that's what they said—to quote Dave Barry, "I am not making this up." See for yourself. *In re* Kalter,

(but not all) of these decisions are federal cases, where one might initially expect better judging and better lawyering.[119]

In once discussing some of the federal decisions with my friend and former Missouri colleague, Chris Guthrie, he half-jokingly (at least *I hope* half-jokingly) proposed an explanation that I dubbed the Guthrie Hypothesis in his honor—that federal judges disproportionately have clerks from elite law schools, where students don't take a UCC course and thus would be most likely to misinterpret it in drafting opinions. While clever—and perhaps accurate as far as the study of the UCC at some elite law schools—the Guthrie Hypothesis presents an unlikely explanation for the security deposit cases. A cursory reading of some of the security deposit cases suggests that they were not a product of bad lawyering—lawyers for the plaintiffs put forward arguments similar to the ones presented in Part I of this article, to little apparent avail. The horses were led to water, but simply refused to drink.

So in considering the security deposit cases, I began to ponder a different hypothesis. What did these courts hope to gain by excluding security deposits from Article 9, rather than deciding the cases on the merits of the lessor's conduct (as suggested in Part I)? If the cases were decided on the merits, each case would require discovery regarding the lessor's actual handling of security deposits (i.e., did the lessor earn interest on security deposits that would presumptively be payable to lessees under Section 9-207?) before the case could be resolved.[120] In contrast, if the court concluded that Article 9 excluded security deposits from its scope and instead concluded that a lessor has no common law duty to pay interest on security deposits, the court could dispose of a security deposit case on the pleadings—both clearing the case off its docket and effectively discourage the filing of any future case involving entitlement to interest on security deposits under Section 9-207.

In this regard, it is important to recognize that a security deposit case presents the quintessential "small-dollar" consumer class action. At most, any individual lessee has only a few dollars at stake.[121] Thus, a security deposit case will proceed only if an attorney expends the time and effort to identify and assemble a class of similarly-situated plaintiffs—and in reality, the attorney may be the only party who will enjoy any significant economic benefit from the

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292 F.3d 1350, 1353-60 (11th Cir. 2002).

119. Indeed, while not all of the security deposit cases are federal cases, *see supra* notes 3-9, many of the state court decisions have cited and relied upon the federal court decisions. Thus, it is arguable that the federal security deposit cases have been most influential in the resolution of these disputes.

120. This inquiry would be obviated, of course, if the lessor's form lease disclaimed any obligation to pay interest on security deposits.

121. *See supra* note 15.

litigation.[122] Indeed, as the class action has become increasingly prevalent over the past two decades, there has been increasing criticism that prosecution of "small-dollar" consumer class action cases—where recovery by individual class plaintiffs is likely to be trivial—is primarily rent-seeking behavior by attorneys seeking to manufacture fee claims.[123] This has led some to argue that prosecution of small-dollar consumer class action cases is socially wasteful and that the law should impose substantive and procedural constraints to prevent or discourage such cases. To date, however, efforts to effect legislative reform have failed.[124] Thus, in considering the security deposit cases, I began to speculate whether courts are simply using their power to interpret statutes as a means to effect law reform—that is to say, are the courts misinterpreting Article 9's scope as a means to dismiss security deposit cases because they perceive such complaints as abusive attorney rent-seeking? Might the security deposit cases reflect conscious or unconscious judicial bias against the litigation of small-dollar consumer class action disputes? Part II explores these questions, tracing the historical development of consumer class actions[125] and the extent to which courts have used unorthodox and/or debatable statutory interpretation techniques to dismiss or hinder consumer class actions in other contexts.[126]

A. The Early Nature and History of Consumer Class Actions

Inevitably, the security deposit cases arise as consumer class action disputes. Given the economics facing any individual lessee, this is not a surprise. In our litigation system, some persons who suffer legal injury cannot obtain effective redress because the cost of pursuing it would exceed the amount those persons could reasonably expect to recover through litigation.[127] Where an actor causes numerous persons to suffer similar injuries—for example, where Ford Motor Credit refuses to reimburse to lessees interest that it allegedly owes to those lessees on their security deposits—public agencies could theoretically address this problem through aggressive regulatory enforcement designed to deter the harm-causing conduct. In practice, however, regulators often lack

122. *See infra* notes 131-37 and accompanying text.

123. *See infra* note 151.

124. *See infra* notes 138-56 and accompanying text.

125. *See infra* notes 127-56 and accompanying text.

126. *See infra* notes 157-92 and accompanying text.

127. With respect to small-dollar claims, this phenomenon is largely a by-product of the American rule, under which the court lacks authority to award legal fees to a litigant (regardless of outcome) absent statutory authority or express contractual agreement. *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975); Barnes v. Okla. Farm Bureau Mut. Ins. Co., 11 P.3d 162, 178-79 (Okla. 2000). By contrast, a "loser-pays" litigation system could ameliorate (in part) the cost barrier to pursuit of small-dollar claims.

sufficient funding to pursue aggressive enforcement efforts, or simply choose not to do so.[128] Under such circumstances (and in the absence of fee-shifting regimes), injurers have a significantly reduced incentive to avoid engaging in injurious conduct.

The class action provides a theoretical solution to this otherwise intractable externalities problem, allowing persons with similar claims to reduce the cost of obtaining redress by pursuing their claims collectively in one proceeding.[129] In theory, the class action provides the injured with increased access to the legal system and deters future injuries by making it more likely that actors will internalize the costs of their future misconduct. In practice, however, the class action has become a lightning rod for criticism—much of it alleging that the class action's structure fosters the objectives of attorney autonomy and compensation to the extent that it produces socially wasteful litigation.

In contrast to the traditional civil action—in which the client makes critical decisions regarding pursuit and/or settlement of the action[130]—the modern class action is essentially driven entirely by the attorney for the class representative, for a variety of reasons. First (and perhaps foremost) is the fact that class actions are almost exclusively contingent fee lawsuits. Even though the class action enables individual claimants to share the cost of litigation, each individual claimant would be understandably reluctant to assume joint and several liability for the cost of attorney fees necessary to certify a class and litigate the claim to judgment—and particularly so in cases where that claimant's expected recovery was small or the defendant's liability was not clear.[131] Thus, the attorney for the

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128. *See, e.g.*, Deborah R. Hensler & Thomas D. Rowe, Jr., *Beyond "It Just Ain't Worth It": Alternative Strategies for Damage Class Action Reform*, 64 LAW & CONTEMP. PROBS. 137, 137 (Spring/Summer 2001) ("[D]amage class actions can deter such injurious behavior and thereby supplement regulatory enforcement by administrative agencies that are under-funded, susceptible to capture by the subjects of their regulation, or politically constrained.").

129. Obviously, the class action provides no assistance to the person whose injury is sui generis. Such a plaintiff cannot overcome the cost barrier to litigation absent the adoption of some fee-shifting regime such as "loser pays."

130. Technically, these decisions belong to the client regardless of whether the lawsuit is a traditional civil action or a class action. Model Rules of Professional Conduct Rule 1.2(a)—which draws no distinction between class actions and non-class actions—makes clear that "[a] lawyer shall abide by a client's decision concerning the objectives of representation . . . [and] shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to settle a matter." MODEL RULES OF PROF. CONDUCT R. 1.2(a) (2003). Nevertheless, for the reasons discussed in the text, the procedural dynamics and the economics of consumer class actions combine to give class action attorneys nearly complete authority in such cases.

131. Presumably, 100 plaintiffs could agree to pay an attorney $100,000 to represent them in pursuing a collective claim, such that each plaintiff would expect a

class representative typically (if not exclusively) agrees to represent the plaintiff class on a contingent fee basis, thereby minimizing the financial risks for the individual plaintiffs.[132] Second, even if a small claimant holds a claim which can be aggregated with other similar claims, she typically lacks the financial incentive or wherewithal to invest in identifying the holders of similar claims. In the typical case, the attorney for the class representative must perform this function. Third, where individual class members have relatively small claims, they also have diminished incentive to monitor actively the progress of the case or the performance of the attorney for the class representative. As a result, "class actions are effectively run by class counsel" who "exercise virtually complete control over litigation decisions."[133]

This dominance, and the extent to which courts have structurally reinforced it,[134] creates significant financial incentives for attorneys to prosecute class actions in a fashion that may thwart the class action's ostensible objectives. While the class members would prefer that the attorney for the class act so as to maximize each member's recovery, the attorney (who principally bears the financial risk of the litigation) has a conflicting incentive to act in a fashion that will maximize the fee award. As Deborah Hensler and Tom Rowe have noted, critics have observed that these conflicting incentives may produce perverse settlements:

> [S]ome plaintiffs' attorneys search out defendants who can be easily persuaded to settle [nuisance] claims, often earning attorneys' fees that are disproportionate to the modest effort and expense required to

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$1,000 "share" of the bill. The attorney could, of course, agree that each plaintiff's liability was limited to $1,000; however, that attorney would assume the risk of each plaintiff's insolvency. As a result, one would expect the attorney representing this class to insist that each plaintiff be jointly and severally liable for the full fee, thereby shifting the risk of each plaintiff's insolvency onto the other plaintiffs.

132. Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 55 (Spring/Summer 2001); George L. Priest, *Procedural Versus Substantive Controls of Mass Tort Class Actions*, 26 J. LEG. STUD. 521, 560 (1997).

133. Fisch, *supra* note 132, at 56.

134. For example, courts have concluded that the class representative does not have the right to unilaterally replace counsel for the class (as would presumptively be the case outside the class action setting). *See, e.g.*, Maywalt v. Parker & Parsley Petroleum Co., 67 F.3d 1072, 1078 (2d Cir. 1995); Bash v. Firstmark Standard Life Ins. Co., 861 F.2d 159, 161 (7th Cir. 1988). Further, courts have concluded that counsel for the class could propose a settlement without the approval or consultation of the class representative. Lazy Oil Co. v. Witco Corp., 166 F.3d 581, 590-91 (3d Cir. 1999); Laskey v. UAW, 638 F.2d 954, 957 (6th Cir. 1981). *See generally* John C. Coffee, Jr., *Class Action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, 100 COLUM. L. REV. 370 (2000).

> achieve these settlements. Conversely, some defendants who face stronger claims may seek out plaintiffs' attorneys who are willing to settle such claims at less than their true value in exchange for fees that arguably are more generous than they deserve, given what they have obtained for their class clients. In both instances, the defendants buy *res judicata* at an inappropriate price: In the first instance, they pay too much (and the plaintiffs' attorneys pocket the premium); in the second, they pay too little (and class members suffer the loss). In both instances, because clients in representative litigation usually cannot effectively control their attorneys, unfaithful plaintiff attorney-agents are free to pursue their own interests. In addition, the deterrent signals of litigation are distorted because the costs of the harms that are imposed on the class are not properly reflected by settlement outcomes.[135]

Furthermore, critics charge that because courts are structurally biased in favor of settlement, courts are not providing an effective check upon the extent to which class action settlement decisions may compromise the class action's overall utility as a representative tool.[136]

These structural problems may produce class action litigation in which class members have so little to gain that prosecution of the action can be explained only as an attempt by the class attorney to "create" a fee. Arguably, the lease security deposit cases fit this model. The typical auto lessee makes a security deposit of $200 to $800 for a period of two to three years. In a best-case

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135. Hensler & Rowe, *supra* note 128, at 138.

136. As Jonathan Macey and Geoffrey Miller have observed:

> Unfortunately, judicial approval [of settlements] appears to be highly imperfect as a protection for the plaintiffs' interests, for several reasons. First, and most important, the judge herself has a powerful interest in approving the settlement. Judges' calendars are crowded with cases, and despite various reform efforts, the workload only seems to increase. If the judge approves the settlement, the result will be to remove a potentially complex and time-consuming case from the judge's calendar; if she rejects it she faces a substantial probability of further litigation. A judge faces virtually no prospect of reversal for approving a settlement, whereas a decision rejecting a settlement might well be appealed. Moreover, trial judges are heavily conditioned by the ethos of their jobs to view settlements as desirable; they routinely encourage settlement in other contexts.

Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 45-46 (1991). Macey and Miller further argued that courts often lack sufficient evidence to conduct an informed evaluation of proposed settlements, and that parties with objections to the settlement are unlikely to be present at settlement hearings. *Id.* at 46-47.

scenario, individual class members could expect a recovery of $25 or less—with any such recovery reduced by the class attorney's fee. Settlement would presumably produce an even smaller recovery for class members.[137] Any individual class member's recovery would scarcely (if at all) compensate for the administrative hassle she would incur in identifying herself as a class member. Further, to the extent that the defendant can effectively pass the cost of litigation and settlement negotiation on to future consumers, one can argue that settlements in such cases do not advance the welfare of consumers as a whole. As a result, one can at least *debate* whether the small-dollar consumer class action game is worth the candle, or whether prosecution of such lawsuits is an abuse of the judicial process.

B. Federal Rule 23, Consumer Class Actions, Reiter v. United States, *and Reform Efforts: Does It Matter Whether the Game Is Worth the Candle?*

While the utility of consumer class actions may be a legitimate subject of debate, Federal Rule 23 did not authorize courts to undertake overt cost-benefit analysis in deciding whether or not to certify a class. This suggests that Congress did not sanction the use of judicial authority to make the class action mechanism unavailable to plaintiff class members suffering an otherwise de minimis financial injury. Nevertheless, to the extent concerns remain about the overall welfare effects of these cases, judges who viewed small-dollar class actions as socially wasteful might be inclined to interpret the applicable legal

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137. In fact, many consumer class action settlements tend to provide compensation to plaintiffs via "couponing"—under which the plaintiffs receive only credit against future purchases or services. Such a structure provides minimal or no recovery to the plaintiff who no longer wished to contract with the defendant, and thus renders the settlement worthless to many class members. *See, e.g.*, Christopher R. Leslie, *A Market-Based Approach to Coupon Settlements in Antitrust and Consumer Class Action Litigation*, 49 UCLA L. REV. 991, 1086-98 (2002) (proposing that courts should police coupon settlements by approving them only when the class attorney's fee is paid in coupons as well); Geoffrey P. Miller & Lori S. Singer, *Nonpecuniary Class Action Settlements*, 60 LAW & CONTEMP. PROBS. 97, 119-24 (Autumn 1997) (discussing safeguards that might protect against undesirable coupon settlements).

In its attempts at class action reform, Congress has identified such settlements as troublesome; its proffered findings in support of the proposed Class Action Fairness Act of 2002 stated that "[c]lass members have been harmed by a number of actions taken by plaintiffs' lawyers, which provide little or no benefit to class members as a whole, including . . . plaintiffs' lawyers receiving large fees, while class members are left with coupons or other awards of little or no value." H.R. 2341, 107th Congress § 2(a)(3) (2002). As yet, however, reform efforts have proven unsuccessful.

standards in a fashion that might accomplish the same result—dismissal of small-dollar class action suits—on the merits.

The Supreme Court's 1979 decision in *Reiter v. Sonotone Corp.*[138] both recognizes and ostensibly rebukes such a reaction by federal judges. In that dispute, Reiter filed a class action suit against Sonotone and four other hearing aid manufacturers, alleging that they had engaged in price fixing and other violations of Sections 1 and 2 of the Sherman Act[139] and Section 3 of the Clayton Act.[140] Reiter alleged that these actions forced class members to pay illegally-fixed higher prices for hearing aids and related services purchased from retail dealers, and sought both treble damages and injunctive relief. Sonotone sought summary judgment, arguing that Reiter was only a retail purchaser of hearing aids for personal use and thus lacked standing to sue for treble damages, because she had not been injured in her "business or property" within the meaning of Section 4 of the Clayton Act.[141] The United States District Court for the District of Minnesota held that a retail purchaser of an item suffered injury in "property" under Section 4 of the Clayton Act if she could show that antitrust violations caused an increase in the price she paid for the item,[142] but nevertheless certified this issue for interlocutory appeal, noting the existence of "substantial ground for difference of opinion."[143]

In a unanimous opinion, a panel of the United States Court of Appeals for the Eighth Circuit reversed, holding that consumers who allege no injury of a "commercial or business nature" have not suffered an injury in "business or property" within the meaning of Section 4.[144] Expressing agreement with several district court decisions,[145] the Eighth Circuit panel concluded that the phrase "business or property" limited standing to persons engaged in *commercial interests or enterprises*. In bolstering its judgment, the panel expressly articulated a strong suspicion of the utility of the class action device:

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138. 442 U.S. 330 (1979).

139. 15 U.S.C. §§ 1-2 (2000).

140. *Id.* § 14.

141. "[A]ny person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . . without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee." 15 U.S.C. § 15 (2000).

142. Reiter v. Sonotone Corp., 435 F. Supp. 933, 936 (D. Minn. 1977), *rev'd*, 579 F.2d 1077 (8th Cir. 1978), *rev'd*, 442 U.S. 330 (1979).

143. *Id.* at 938.

144. Reiter v. Sonotone Corp., 579 F.2d 1077, 1079 (8th Cir. 1978), *rev'd*, 442 U.S. 330 (1979).

145. Weinberg v. Federated Dep't Stores, 426 F. Supp. 880 (N.D. Cal. 1977); Gutierrez v. E & J Gallo Winery Co., 425 F. Supp. 1221 (N.D. Cal. 1977), *aff'd in part, vacated in part*, 604 F.2d 645 (9th Cir. 1979).

> The goals and purposes of the antitrust laws may not be enhanced by permitting gigantic consumer class actions, many of which are never tried . . . . Often, defendants who are unwilling or unable to defend such suits are compelled for economic reasons to settle actions otherwise meritless. The result of such settlements will inevitably be counterproductive when the costs to the defendant of defense and settlement are passed on to present and future consumers. Moreover, big firms are better able than small or medium-sized businesses to defend or settle such claims under similar circumstances. The ultimate result might be to preserve an oligopolistic economic climate. The deterrent impact of such suits, in our view, does not outweigh their potentially ruinous effect on American business.[146]

The Eighth Circuit concluded that state attorneys general could act "to protect the interests of consumers without imposing upon the courts and the economy the risk and burden of nonmeritorious class actions."[147]

In a unanimous opinion, the United States Supreme Court reversed the Eighth Circuit and ruled that Reiter had standing under Section 4. Engaging in what it considered a straightforward interpretation of the statutory language, the Court concluded that "*any* person" intuitively included consumers as well as business persons, and that the term "business or property" should be understood in the disjunctive.[148] The Court's opinion is perhaps most noteworthy, however,

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146. *Reiter*, 579 F.2d at 1086. Reiter petitioned for rehearing en banc, which the court denied over the objection of three nonpanel members, who suggested that the panel opinion represented "a policy judgment beyond the province of the judiciary." *Id.* at 1087 (Lay, C.J., dissenting from denial of rehearing en banc).

147. *Id.* at 1086.

148. *Reiter*, 442 U.S. at 339. The Court stated:

> When a commercial enterprise suffers a loss of money it suffers an injury in both its "business" and its "property." But neither term is rendered redundant by recognizing that a consumer not engaged in a "business" enterprise, but rather acquiring goods or services for personal use, is injured in "property" when the price of those goods or services is artificially inflated by reason of the anticompetitive conduct complained of. The phrase "business or property" also retains restrictive significance. It would, for example, exclude personal injuries suffered. Congress must have intended to exclude some class of injuries by the phrase "business or property." But it taxes the ordinary meaning of common terms to argue, as respondents do, that a consumer's monetary injury arising directly out of a retail purchase is not comprehended by the natural and usual meaning of the phrase "business or property." We simply give the word "property" the independent significance to which it is entitled in this context.

Id. (citations omitted).

for its stinging rebuke of the Eighth Circuit's narrow policy-based interpretation of Section 4:

> Respondents also argue that allowing class actions to be brought by retail consumers like the petitioner here will add a significant burden to the already crowded dockets of the federal courts. That may well be true but cannot be a controlling consideration here. We must take the statute as we find it. Congress created the treble-damages remedy of § 4 precisely for the purpose of encouraging *private* challenges to antitrust violations. These private suits provide a significant supplement to the limited resources available to the Department of Justice for enforcing the antitrust laws and deterring violations . . . . To be sure, these private suits impose a heavy litigation burden on the federal courts; it is the clear responsibility of Congress to provide the judicial resources necessary to execute its mandates.
>
> Finally, respondents argue that the cost of defending consumer class actions will have a potentially ruinous effect on small businesses in particular and will ultimately be paid by consumers in any event. These are not unimportant considerations, but they are policy considerations more properly addressed to Congress than to this Court. However accurate respondents' arguments may prove to be—and they are not without substance—they cannot govern our reading of the plain language in § 4.[149]

Reiter's language provides strong rhetorical condemnation of judges adopting strained or counterintuitive statutory interpretation based upon doubts about the utility of small-dollar class action litigation. Yet the Court also acknowledged that utility-based criticism of the class action device was "not without substance." And this criticism grew in volume throughout the 1980s, as courts experienced burgeoning growth in mass tort class action disputes. Eventually, the volume of criticism prompted Congress to turn to the Federal Civil Rules Advisory Committee ("FCRAC") for reform proposals.

In 1996, after six years of study, the FCRAC proposed eight changes to Rule 23.[150] One of these changes—motivated primarily by criticism that judges frequently certified class actions in cases where class members had little to gain—would have directed judges to consider in the certification decision "whether the probable relief to individual class members justifies the costs and burdens of class litigation."[151] This cost-benefit test—dubbed the "it just ain't

149. *Id.* at 344-45 (citations omitted).

150. Proposed Amendments to the Federal Rules of Civil Procedure, 167 F.R.D. 559 (1996).

151. *Id.* For example, one critic offered the following testimony before the

worth it" rule[152]—met with significant opposition, including a letter from 129 law professors who opposed the rule because of their view that the availability of small-dollar class actions was essential to deter corporate misconduct.[153] After receiving testimony from over 140 witnesses—much of that testimony focused upon the "it just ain't worth it" rule[154]—the FCRAC recognized that controversy over the scope and purpose of Rule 23 was intractable and that further debate

FCRAC:

> In many instances, the value of recovery to the individual class member is so negligible that it fails to offset the associated cost imposed on the defendants and the judicial system. Those types of claims only enrich the few counsel whose fees are based on the total aggregation with little or no benefit for the individual class member.

D. DUDLEY OLDHAM, 4 WORKING PAPERS OF THE ADVISORY COMMITTEE ON CIVIL RULES ON PROPOSED AMENDMENTS TO RULE 23 505 (1997), *quoted in* DEBORAH R. HENSLER ET AL., CLASS ACTION DILEMMAS: PURSUING PUBLIC GOALS FOR PRIVATE GAIN 33 & n.125 (2000) [hereinafter CLASS ACTION DILEMMAS].

152. Hensler & Rowe, *supra* note 128, at 142; CLASS ACTION DILEMMAS, *supra* note 151, at 31.

153. CLASS ACTION DILEMMAS, *supra* note 151, at 31.

154. CLASS ACTION DILEMMAS, *supra* note 151, at 473 ("The 'just ain't worth it' rule was a primary focus of debate during the period of public comment on the proposed revisions, arousing strong support from the business community and strong opposition from consumer public interest advocates and consumer class action attorneys. It was only after multiple committee discussions, hours of oral testimony, and hundreds of pages of written commentary that the committee put aside the proposal to include such a 'cost-benefit' test among the criteria for certification.").

was unlikely to produce consensus on a workable solution.[155] Thus, in October 1997, the FCRAC tabled the proposed Rule 23 amendments.

To date, Rule 23 still contains no formal cost-benefit standard as a predicate to class certification. While Congress has introduced a number of bills intended to effect class action reform, none have been successfully enacted, and none have incorporated cost-benefit analysis as a predicate to certification.[156] Further, while the U.S. Judicial Conference approved proposed changes to Rule 23 in September 2002, the proposed amendments focus primarily upon certification procedures (e.g., the timing of certification and notice requirements), not on the substantive merits of whether the court should certify a class.

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155. CLASS ACTION DILEMMAS, *supra* note 151, at 31 ("The effort to amend Rule 23 to include a cost-benefit test for certification foundered on disagreement about the social value of class actions, particularly lawsuits involving small losses to class members."); Hensler & Rowe, *supra* note 128, at 142 (noting political and practical difficulties that led to abandonment of the cost-benefit standard).

John Frank, a member of the FCRAC in 1996, made the following general observation regarding the revision effort:

> [F]or all our efforts, we do not know whether [the Rule 23(b)(3) class action] is a good or a bad thing. The great big question is whether the social utility of the large class action outweighs the limited benefits to individuals, the aroma of gross profiteering, and the transactional costs to the court system. On this ultimate question, we are no wiser than we were in the beginning. We know that the defendants think that they have been blighted, that the plaintiffs' bar thinks it has done much good and not charged a nickel too much, and that courts have been busy. We know an important negative: the wit of man has not devised a better method for compensating large dispersed losses.

John P. Frank, Whither Rule 23: Memorandum to the Honorable Patrick E. Higginbotham (April 28, 1995), *quoted in* CLASS ACTION DILEMMAS, *supra* note 151, at 35.

156. The most recent such bill was the proposed Class Action Fairness Act of 2002, H.R. 2341, 107th Cong. (2002). The proposed Act would have enacted a series of reforms, including (a) a consumer class action "bill of rights" requiring "plain English" requirements for settlement notices, full disclosure of attorney's fees, and heightened judicial scrutiny of settlements involving couponing, "bounties" to the class representative, or discriminatory payments based on the geographic location of class members; (b) the creation of federal jurisdiction over class actions between diverse parties with more than $2,000,000 in controversy, with class members being permitted to aggregate small-dollar claims to satisfy the amount-in-controversy requirement; and (c) express authorization for the removal of interstate class actions from state courts. While the House adopted H.R. 2341, the 107th Congress adjourned without further action on the bill.

C. Has Anti-Class Action Bias Influenced Statutory Interpretation Despite Reiter?

When reading the security deposit cases against the backdrop of the debate over the utility of class actions and the fate of the "it just ain't worth it" rule, one naturally begins to wonder whether the security deposit cases—and their incorrect interpretations of UCC Sections 1-201(37) and 9-207—reflect latent judicial bias against the utility of small-dollar class action suits. Even prior to *Reiter*, skeptics offered anecdotal critique that a particular judge's view concerning the utility of the class action device disproportionately influenced outcomes:

> A class action lawsuit is much like a game of Russian roulette. It depends almost entirely on the philosophy of the judge trying the lawsuit. If he thinks class action suits serve a useful social purpose, then he will find grounds for continuing the action. If, on the other hand, he thinks the particular case deals with a nit-picking problem of no social consequence, and if he joins that with a view that class action lawsuits unnecessarily clog court calendars, then he will probably dismiss the action.[157]

This observation raises at least two potential (and somewhat related) concerns with respect to small-dollar class action cases: (a) that judges who frequently hear these cases may be disproportionately skeptical of the substantive merits of the claims, and (b) that concerns of judicial economy create incentives for judges facing such cases to adopt pro-defendant interpretations of procedural and/or substantive rules in order to clear such cases off their dockets.[158] To the extent

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157. Eleanore Carruth, *The "Legal Explosion" Has Left Business Shell-Shocked*, FORTUNE, April 1973, at 66 (quoting G. Edward Fitzgerald of Gibson, Dunn & Crutcher).

158. In their empirical study of decisions interpreting the 1995 Private Securities Litigation Reform Act ("PSLRA"), Joseph Grundfest and A.C. Pritchard labeled these respective concerns as the "familiarity breeds skepticism" hypothesis and the "docket control" hypothesis. Joseph A. Grundfest & A.C. Pritchard, *Statutes with Multiple Personality Disorders: The Value of Ambiguity in Statutory Design and Interpretation*, 54 STAN. L. REV. 627, 680 (2002). In the consumer class action setting, of course, the "familiarity breeds skepticism" concept could in some sense subsume the "it's just not worth it" problem. In other words, a court might be skeptical about a particular consumer class action case either (a) because it believes that the case lacks substantive merit under the applicable legal standards, or (b) because it believes that the case may have merit under the applicable legal standard but "just isn't worth it" given that individual class members stand to achieve only a de minimis recovery.

The data collected by Grundfest and Pritchard provide some support for the notion that these skepticism concerns may influence judicial statutory interpretation. In their that judges perceive that the legislative process has failed to requite legitimate concerns about the utility and/or abuse of the class action device, might these judges be exercising "self-help" through statutory interpretation, in order to get rid of marginal or "economically meritless" consumer class actions? At this point, available empirical evidence neither confirms nor denies such a hypothesis, but as discussed below, there is enough anecdotal noise to merit empirical study.

1. The Lanham Act and Consumer False Advertising Class Actions

As Jean Wegman Burns has shown elsewhere,[159] skepticism and docket control concerns have manifestly influenced statutory interpretation in consumer class action cases seeking damages for false advertising under Section 43(a) of the Lanham Act.[160] Section 43(a) provides that "any person who believes that he or she is or is likely to be damaged" by a misrepresentation of the characteristics, qualities, or geographic origin of goods or services may maintain a civil action. As Professor Burns and others have argued, most persons would understand the words "any person" in Section 43(a) to include consumers as well as the defendant's business rivals.[161] Certainly, such an interpretation would mesh naturally with the Supreme Court's interpretation in *Reiter* of the identical words as used in the Clayton Act.[162] Nevertheless, the majority of decisions have

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study, Grundfest and Pritchard looked at district court decisions interpreting and applying the PSLRA's "strong inference" pleading standard in securities fraud class action litigation. They discovered that variables such as presence of the litigation in the Northern District of California (where high-tech securities issuers are disproportionately located vis-a-vis other districts), the intensity of class action securities fraud litigation within a district, and the intensity of litigation against technology issuers within a district all correlated significantly with pro-defendant interpretations of the "strong inference" standard and with pro-defendant rulings on motions to dismiss. *Id.* at 679-80. Grundfest and Pritchard observed that such a decisionmaking pattern could be consistent with either the "familiarity breeds skepticism" hypothesis or the "docket control" hypothesis, but concluded that their data were more consistent with the former. *Id.* at 680.

159. Jean Wegman Burns, *Confused Jurisprudence: False Advertising Under the Lanham Act*, 79 B.U. L. REV. 807 (1999).

160. 15 U.S.C. § 1125(a) (2000).

161. Burns, *supra* note 159, at 877 ("Put simply, the language of [Section 43(a)] provides for buyer standing, and logically, the goal of consumer protection demands it."); Andrew A. Gallo, *False and Comparative Advertising Under Section 43(a) of the Lanham Trademark Act*, 8 COMM. & L. 3, 15-20 (1986) (decisions denying consumer standing are based upon incorrect statutory construction and bad policy).

162. Reiter v. Sonotone Corp., 442 U.S. 330, 339 (1979), discussed *supra* notes 138-49 and accompanying text. On this theory, the Third and Ninth Circuits initially recognized consumer standing under Section 43(a). *See, e.g.*, Smith v. Montoro, 648 F.2d 601, 607 (9th Cir.1981) (adopting plain meaning interpretation of Section 43(a));

denied consumers standing to sue on a variety of theories that reflect implicit skepticism about the general merits of consumer actions, such as: (1) the entire statute was intended to protect primarily competitors rather than consumers;[163] (2) rivals would be better plaintiffs because of their greater financial resources;[164] (3) competitors' victories would inevitably redound to the benefit of any deceived consumers;[165] and (4) the FTC could seek redress on behalf of consumers under the FTCA.[166] Many of these decisions expressly justified their narrow interpretation (or disregard) for Section 43(a)'s "any person" language by suggesting that a literal reading would overwhelm federal dockets.[167] Further, many of the recent decisions have used selective reference to Section 43(a)'s legislative history to support the view that Congress would not have intended such a result. Perhaps most illustrative is the Third Circuit's decision in *Serbin v. Ziebart International Corp.* The court in *Serbin* noted that during the

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Thorn v. Reliance Van Co. Inc., 736 F.2d 929, 932 (3d Cir. 1984) (same). However, following the Trademark Law Revision Act of 1988, Pub. L. No. 100-667, 102 Stat. 3935 (1988), courts in both circuits have since issued decisions denying consumer standing under Section 43(a)—*even though the operative language of Section 43(a) was not changed. See, e.g.*, Barrus v. Sylvania, 55 F.3d 468, 469-70 (9th Cir. 1995); Serbin v. Ziebart Int'l Corp., 11 F.3d 1163, 1177-80 (3d Cir. 1993).

163. *See, e.g.*, Sandoz Pharm. Corp. v. Richardson-Vicks, Inc., 902 F.2d 222, 230 (3d Cir. 1990) (Lanham Act is "primarily intended to protect commercial interests"); Colligan v. Activities Club of N.Y., Ltd., 442 F.2d 686, 692 (2d Cir. 1971) ("Congress' purpose in enacting § 43(a) was to create a special and limited unfair competition remedy, virtually without regard for the interests of consumers generally and almost certainly without any consideration of consumer rights of action in particular. The Act's purpose . . . is exclusively to protect the interests of a purely commercial class against unscrupulous commercial conduct.").

164. *See, e.g.*, Coca-Cola Co. v. Procter & Gamble Co., 822 F.2d 28, 31 (6th Cir. 1987) ("[C]ompetitors have the greatest interest in stopping misleading advertising, and a private cause of action under Section 43(a) allows those parties with the greatest interest in enforcement, and in many situations with the greatest resources to devote to a lawsuit, to enforce the statute rigorously.").

165. *See, e.g.*, Alpo Petfoods, Inc. v. Ralston Purina Co., 720 F. Supp. 194, 212 (D.D.C. 1989) ("While the Act is not directly available to consumers, it is nevertheless designed to protect consumers, by giving the cause of action to competitors who are prepared to vindicate the injury caused to consumers.").

166. *See, e.g.*, *Colligan*, 442 F.2d at 694 n.37 ("Although we hold that consumers have no right of action under § 43(a), we note that the federal government through the Federal Trade Commission has intervened in the marketplace and in the courts to vindicate the rights of the consuming public.").

167. *See, e.g.*, *id.* at 693 ("[Consumer suits] would lead to a veritable flood of claims brought in already overtaxed federal district courts."); Maguire v. Sandy Mac, Inc., 145 F.R.D. 50, 53-54 (D.N.J. 1992) (denying class certification, the court also noted that "one problematic consequence of extending Lanham Act coverage to consumers would be the transformation of the federal court system into a veritable small claims court").

legislative process leading to the Trademark Law Revision Act of 1988—in which Congress made no actual change in the relevant language of Section 43(a)—the House Judiciary Committee had favorably reported a bill that would have amended Section 43(a) to read "any person, including a consumer."[168] Noting that the conference committee deleted the "including a consumer" language, the Third Circuit concluded that the deletion provided persuasive evidence of Congress's intent to accept existing judicial interpretations of Section 43(a) denying consumer standing. In further support of this conclusion, the Third Circuit cited a floor statement in which Representative Fish explicitly raised docket control concerns:

> I would like to comment on one provision which was taken out of H.R. 5372 which was reported by the Judiciary Committee and which is not found in this compromise, it would have provided consumers with standing to sue under section 43(a) of the Lanham Act. This provision, which had not been studied or evaluated by anyone for its long-term effects on Federal unfair competition law, would have radically altered the nature of the Lanham Act and would have had the likely effect of turning the Federal courts into a small claims court.[169]

Explicitly using "docket control" concerns as an interpretive tool, the *Serbin* court concluded that "if Congress had intended to make the additional commitment involved in recognizing a federal tort of misrepresentation and in bestowing access to federal fora without regard to the amount in issue, we are confident that the legislative history of the Lanham Act would have borne clear witness to that commitment."[170]

There are two problems with the *Serbin* court's analysis. First, the analysis is premised on the assumption that pre-1988 case law on consumer standing was settled—and thus that the 1988 amendments embraced that settled principle. But pre-1988 case law was most certainly *not* settled; at least two circuits had recognized consumer standing in Section 43(a) cases.[171] Thus, Congress's "removal" of the "including a consumer" language is also quite consistent with the view that the language was superfluous because "any person" *already* included consumers. Second, the *Serbin* court simply fails, without explanation, to acknowledge the profound inconsistency between its interpretive methodology and that of the Supreme Court in *Reiter*—in which the court interpreted the same words "any person" to include consumers when used in Section 4 of the Clayton Act. The same policy-based concerns about overburdening the federal

168. H.R. REP. NO. 100-1028, at 32 (1988).

169. 134 CONG. REC. 31,854 (Oct. 19, 1988).

170. Serbin v. Ziebart Int'l Corp., 11 F.3d 1163, 1178 (1993).

171. *See supra* note 162.

courts—rejected by the Supreme Court as a legitimate interpretive tool in *Reiter*—predominate the court's reasoning in *Serbin*.[172]

The point is not to debate the wisdom of federal jurisdiction over consumer class actions asserting false advertising. Instead, the point is that *Serbin* followed fourteen years of post-*Reiter* experience with the perceived abuse of the class action device, and failed legislative attempts to revise Rule 23 to address this perceived abuse. Decisions like *Serbin* may reflect that some judges—suspicious of the economic utility of consumer class action cases and/or frustrated over Congress' failure to satisfactorily address perceived abuses—may respond by "self-help" and use unorthodox interpretation (or simple disregard) of statutory language as a tool to dispose of those cases.

2. Aggregation of Individual Claims in Diversity Actions

Another example involves the manner in which federal courts have treated the aggregation of individual claims in diversity actions. If one or more members of a purported class have individual claims that satisfy the amount in controversy requirement, but other class members do not, can a federal district court assert supplemental jurisdiction over the otherwise noncompliant claims? In 1969, in *Zahn v. International Paper Co.*,[173] Justice Brennan argued that federal courts should assert ancillary jurisdiction over such small-dollar class action claims in order to provide for the efficient resolution of such disputes:

> Class actions under Rule 23(b)(3) are equally appropriate for such treatment. There are ample assurances, in the provisions of the Rule that "the questions of law or fact common to the members of the class (must) predominate over any questions affecting only members," to guarantee that ancillary jurisdiction will not become a facade hiding attempts to secure federal adjudication of nondiverse parties' disputes over unrelated claims. And the practical reasons for permitting adjudication of the claims of the entire class are certainly as strong as those supporting ancillary jurisdiction over compulsory counterclaims and parties that are entitled to intervene as of right. Class actions were born of necessity. The alternatives were joinder of the entire class, or redundant litigation of the common issues. The cost to the litigants and the drain on the resources of the judiciary resulting from either alternative would have been intolerable.[174]

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172. Burns, *supra* note 159, at 878-79 (noting that such a "result-oriented view" both constitutes "an outright disregard for statutory language" and conflicts with *Reiter*'s interpretive guidelines).

173. 414 U.S. 291 (1973).

174. *Id.* at 306-07 (Brennan, J., dissenting) (footnotes omitted).

Nevertheless, a majority of the Court in *Zahn* concluded that the claim of each individual class member had to satisfy the requisite amount in controversy (then $10,000) in order to establish federal diversity jurisdiction, and that federal courts had to dismiss the claim of any would-be class member that individually lacked the requisite amount in controversy.[175] The result in *Zahn* effectively barred from federal courts any class action disputes not raising federal questions, at least where the proposed class included small-dollar claimants.

In 1990, in the wake of the Supreme Court's decision in *Finley v. United States*[176]—which reiterated the Court's unwillingness to use supplemental jurisdiction as a basis for asserting jurisdiction over pendent parties—Congress enacted a new supplemental jurisdiction statute in response to a recommendation of the Federal Courts Study Committee. The statute, 28 U.S.C. § 1367, provides in pertinent part:

> (a) Except as provided in subsections (b) and (c) or as expressly provided otherwise by Federal statute, in any civil action of which the district courts have original jurisdiction, the district courts shall have supplemental jurisdiction over all other claims that are so related to claims in the action within such original jurisdiction that they form part of the same case or controversy under Article III of the United States Constitution. Such supplemental jurisdiction shall include claims that involve the joinder or intervention of additional parties.
> (b) In any civil action of which the district courts have original jurisdiction founded solely on [diversity], the district courts shall not have supplemental jurisdiction under subsection (a) over claims by plaintiffs against persons made parties under Rule 14, 19, 20, or 24 of the Federal Rules of Civil Procedure, or over claims by persons proposed to be joined as plaintiffs under Rule 19 of such rules, or seeking to intervene as plaintiffs under Rule 24 of such rules, when exercising supplemental jurisdiction over such claims would be inconsistent with the jurisdictional requirements [for diversity jurisdiction].[177]

A facial reading of these provisions appears to permit supplemental jurisdiction over the claims of small-dollar class plaintiffs if at least one class member satisfies the amount in controversy requirement. Section 1367(a) codifies the

175. "Each plaintiff in a Rule 23(b)(3) class action must satisfy the jurisdictional amount, and any plaintiff who does not must be dismissed from the case—'one plaintiff may not ride in on another's coattails.'" *Id.* at 301 (quoting from the Second Circuit's decision dismissing the claims of small-dollar class members).

176. 490 U.S. 545 (1989).

177. 28 U.S.C. § 1367(a)-(b) (2000).

"common nucleus of operative fact" test articulated by the Court in *United Mine Workers v. Gibbs*[178] for establishing jurisdiction over pendent state claims. By definition, if the claims of small-dollar class members are sufficiently related to the class representative's claim so as to qualify the class for certification—if there are questions of law or fact that are common to the claims of all putative class members—then small-dollar class plaintiffs would satisfy the "same case or controversy" standard in Section 1367(a). Further, nothing in Section 1367(b) excepts the class action device, or expressly requires that each class plaintiff must satisfy the amount in controversy requirement. As a result, one adopting the principles of statutory construction similar to those articulated in *Reiter* might justifiably conclude that Section 1367(a) overruled *Zahn*[179]—and the Fifth,[180] Seventh,[181] and Ninth[182] Circuits have so ruled.

Nevertheless, a plethora of district court decisions[183] and appellate decisions by the Third,[184] Eighth,[185] and Tenth[186] Circuits have concluded that Section 1367 had no effect on *Zahn*, and that 28 U.S.C. Section 1332 still required every individual prospective class member to satisfy the requisite amount in controversy. Most of these decisions have relied upon Section 1367's legislative history to justify this conclusion, and—as often happens with legislative history—the history of Section 1367 contains statements seemingly at odds with the statutory language. These include a House committee report suggesting that the statute "essentially restore[s] the pre-*Finley* understandings of the authorization for and limits on . . . supplemental jurisdiction,"[187] and that the

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178. 383 U.S. 715, 725 (1966).

179. *See, e.g.*, Richard D. Freer, *Compounding Confusion and Hampering Diversity: Life After* Finley *and the Supplemental Jurisdiction Statute*, 40 EMORY L.J. 445, 485 (1991) ("[I]f a named class representative's claim invoked diversity jurisdiction, the statute would appear to permit supplemental jurisdiction over claims by class members that did not meet the amount-in-controversy requirement."); *see also* Thomas C. Arthur & Richard D. Freer, *Grasping at Burnt Straws: The Disaster of the Supplemental Jurisdiction Statute*, 40 EMORY L.J. 963, 981 (1991); Joel E. Tasca, Comment, *Judicial Interpretation of the Effect of the Supplemental Jurisdiction Statute on the Complete Amount in Controversy Rule: A Case for Plain Meaning Statutory Construction*, 46 EMORY L.J. 435, 436 (1997).

180. *In re* Abbott Lab., 51 F.3d 524, 528-29 (5th Cir. 1995).

181. Stromberg Metal Works, Inc. v. Press Mech., Inc., 77 F.3d 928, 930-31 (7th Cir. 1996).

182. Gibson v. Chrysler Corp., 261 F.3d 927, 939-40 (9th Cir. 2001).

183. *See* Tasca, *supra* note 179, at 452-53 nn.93-102 (collecting cases).

184. Meritcare, Inc. v. St. Paul Mercury Ins. Co., 166 F.3d 214, 221-22 (3d Cir. 1999).

185. Trimble v. Asarco, Inc., 232 F.3d 946, 961-62 (8th Cir. 2000).

186. Leonhardt v. W. Sugar Co., 160 F.3d 631, 638-41 (10th Cir. 1998).

187. H.R. REP. NO. 101-734 at 28 (1990), *reprinted in* 1990 U.S.C.A.A.N. 6860, 6874.

statute "is not intended to affect the jurisdictional requirements . . . in diversity-only class actions, as those requirements were interpreted prior to *Finley*."[188] Commentators have disagreed over the appropriate interpretation of Section 1367,[189] and the Supreme Court has not yet resolved this circuit split.[190] Although the proposed Class Action Fairness Act of 2002 would have mooted the issue altogether (by establishing diversity jurisdiction over most consumer class actions where total claims aggregated $2 million or more),[191] the 107th Congress adjourned without passing the bill.

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188. *Id.* at 29, *reprinted in* 1990 U.S.C.A.A.N. at 6875.

189. Some scholars—most notably Tom Mengler, Stephen Burbank, and Tom Rowe, who essentially drafted Section 1367—have argued that Section 1367 does not overrule *Zahn*. Thomas M. Mengler et al., *Congress Accepts Supreme Court's Invitation to Codify Supplemental Jurisdiction*, 74 JUDICATURE 213, 215 (1991) ("[T]he legislative history makes clear that Section 1367 is not intended to affect their [class actions under Rule 23] jurisdictional requirements. . . . Thus, the Supreme Court's holdings that . . . all class members must satisfy the amount in controversy requirement, remains good decisional law.").

Nevertheless, in evaluating Section 1367, resort to the legislative history may be somewhat problematic to the extent that there is no clear consensus about the appropriate boundary of that history. For example, within the compiled working papers of the Federal Courts Study Committee comes this gem: "Our proposal would overrule the Supreme Court's decision in Zahn v. International Paper Co., which held that each plaintiff in a federal diversity action must meet the amount in controversy requirement. . . . From a policy standpoint, this decision makes little sense, and we therefore recommend that Congress overrule it." 1 FEDERAL COURTS STUDY COMMITTEE WORKING PAPERS AND SUBCOMMITTEE REPORTS 561 n.33. Is this part of the legitimate history of Section 1367, and if so, what does it mean? Subsequent statements by Professors Burbank, Mengler, and Rowe, *supra*, suggest that this was not the Study Committee's official position and should not be viewed as an authoritative portion of the statute's legislative history. At least one court has explicitly accorded their view substantial deference in concluding that *Zahn* survived Section 1367. *See Meritcare*, 166 F.3d at 220 n.5. Nevertheless, others have cited this passage as if it was the Study Committee's position, *see* Tasca, *supra* note 179, at 447, and the Ninth Circuit alluded to it in holding that Section 1367 overruled *Zahn*. *See* Gibson v. Chrysler Corp., 261 F.3d 927, 936-40 (2001).

190. The Supreme Court granted certiorari in *Free v. Abbott Lab., Inc.*, but eventually affirmed the Fifth Circuit's judgment by an equally divided Court and without issuing a written opinion. 529 U.S. 333 (2000).

191. H.R. 2341, 107th Cong. § 4(a)(2) (2002). The bill would have provided a $2,000,000 amount in controversy requirement for diversity-based class action suits, and would have expressly overruled *Zahn* as applied to consumer class actions: "In any class action, the claims of the individual class members shall be aggregated to determine whether the matter in controversy exceeds the sum or value of $2,000,000, exclusive of interest and costs."

Again, the point is not to suggest that courts acted solely from anti-class action bias in concluding that Section 1367 had no effect on *Zahn*. The appropriate scope of federal subject matter jurisdiction is a controversial subject, and one might argue that the pro-*Zahn* decisions primarily advance federalism concerns rather than anti-class action bias.[192] Nevertheless, preservation of the *Zahn* rule disproportionately impacts small-dollar consumer class action plaintiffs; further, a court could rather easily articulate federalism concerns to mask a general utility objection to consumer class actions. Thus, one cannot entirely dismiss the possibility that judicial interpretation of Section 1367 may in part reflect lingering judicial concern over the inability of the legislative process to address perceived class action abuses.

III. CONCLUSION

More empirical study is needed before making any founded conclusions about the extent to which anti-class action bias actually influences judicial interpretation of statutory language. One cannot say with certainty that the results in the lease security deposit cases are motivated solely by conscious anti-class action bias. Nevertheless, as explained earlier, courts could have resolved the security deposit cases in favor of lessors without so egregiously misinterpreting Article 9. The problem is that under a proper interpretation of Article 9's scope provision, these cases would have required discovery regarding whether the lessor actually invested the deposit and earned a return covered by Section 9-207. By excluding security deposits from Article 9 altogether, the security deposit cases make it possible for similar suits to be dismissed on the pleadings—effectively reducing (if not eliminating) the likelihood that similarly situated lessees would file future suits.

Because there is no other functional justification for courts to interpret Article 9 to exclude coverage of security deposits, reasonable suspicion lingers that the statutory interpretation in these decisions reflects a bias against the utility of consumer class actions—which, in the process, inappropriately threatens the general coherence of Article 9 by manifestly manipulating its scope. Further, to the extent such bias is operating in consumer class action disputes generally, then courts are effectively resolving a political question—the desirability of making available judicial resolution of small-dollar consumer disputes—outside the political process. In contrast, the preferred approach may be renewed efforts to debate whether cost-benefit analysis has any appropriate role in judicial evaluation of small-dollar consumer claims, and (if so) to amend federal and state rules of civil procedure accordingly.

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192. For example, Professor Freer—perhaps Section 1367's most vocal critic—has argued that Section 1367 reflects an inappropriate anti-diversity bias. Freer, *supra* note 179, at 471.