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Article 9 and the Characterization and Treatment of Tenant Security Deposits

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ARTICLE 9 AND THE CHARACTERIZATION AND TREATMENT OF TENANT SECURITY DEPOSITS

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I. INTRODUCTION

Each day, thousands of lessees enter into contracts under which they lease either real or personal property. Under the majority of these contracts, the lessee agrees to pay (and does pay) a “security deposit” to the lessor. The lessor typically agrees to refund the deposit at the conclusion of the lease term if the lessee fully performs its obligations under the lease contract. Is Article 9 relevant to this transaction? Has the lessor taken a “security interest” in the lessee’s property to secure the lessee’s obligations under the lease contract?

A cursory review of the text of Article 9 suggests that the answer may well be “yes.”¹ Section 9-109(a)(1) provides that Article 9 applies “to any transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.”² In turn, section 1-201(b)(35) defines “security interest” as “an interest in personal property or fixtures which secures payment or performance of an obligation.”³ Read together, these two provisions appear to encompass a lessee’s security deposit. When the lessor contracts for and receives funds from the lessee, the lessor arguably takes an interest in personal property belonging to the lessee. The security deposit unquestionably secures the lessee’s obligation to make the bargained-for lease payments and to maintain the physical condition of the leased property. As a result, it is our opinion that the lessor has a security interest in the personal property used by the tenant to pay the security deposit and that

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1. The analysis in this portion of the paper assumes that the tenant delivers tangible personal property to the landlord, as when the tenant makes a security deposit using cash or a check. The analysis differs somewhat, and the application of Article 9 is less clear, if the tenant makes the deposit using a credit card or similar payment mechanism. The issues related to credit-card and similar transactions are discussed *infra* notes 114–24 and accompanying text.

2. U.C.C. § 9-109(a)(1) (2012 Official Text).

3. U.C.C. § 1-201(b)(35) (2012 Official Text).

Article 9 governs the lessor's rights and responsibilities with respect to that property and its proceeds. Some case authority has accepted this straightforward textual analysis.⁴

Unfortunately, most of the decided cases have concluded that a security deposit does not give rise to a security interest.⁵ These decisions inappropriately incorporate into Article 9 a distinction—traditionally expressed in landlord-tenant law during the pre-UCC era—between a “debt” and a “pledge.” Under this view, title to the funds constituting the security deposit is considered to have passed entirely from the lessee to the lessor, with the lessee holding only a debt claim against the lessor.⁶

What difference does it make? There are several reasons why a tenant could justifiably care about the characterization of the security deposit. Perhaps most significantly, a tenant reasonably expects to recover its security deposit at the conclusion of the lease term if the tenant has complied with its lease obligations, regardless of the landlord's financial situation vis-a-vis its other creditors. But if the deposit belongs *exclusively* to the landlord—if the tenant retains no property right in it—the tenant has only a right of reimbursement and no basis for asserting a priority claim as against the landlord's other creditors. As a result, a tenant whose landlord faces financial distress may discover that another creditor has attached or garnished the landlord's assets, including the security deposit, thereby diminishing the landlord's capacity to reimburse the tenant.⁷ By contrast, if the deposit is treated as Article 9 collateral,⁸ the right of the landlord's other creditors to

4. *Demitropolous v. Bank One Milwaukee, N.A.*, 953 F. Supp. 974, 980 (N.D. Ill. 1997) (Article 9 governed security deposit under automobile lease); *In re Atlanta Times, Inc.*, 259 F. Supp. 820, 827 (N.D. Ga. 1966) (Article 9 governed security deposit under equipment lease); *In re Verus Inv. Mgmt., LLC*, 344 B.R. 536, 542–43 (Bankr. N.D. Ohio 2006) (Article 9 governed security deposit in form of certificate of deposit in a commercial real estate lease); *In re Barr*, 180 B.R. 156, 160 (Bankr. N.D. Tex. 1995) (Article 9 governed security deposit securing uninterrupted electrical service).

5. *See, e.g., Pers. Fin. Servs., Inc. v. GMAC*, 169 F. Supp. 2d 49 (D. Conn. 2001); *In re Ford Motor Credit Co. Motor Vehicle Lease Litig.*, No. 95 CIV 1876 (S.D.N.Y. 1998); *Lawson v. Bank One Lexington, N.A.*, 35 F. Supp. 2d 961 (E.D. Ky. 1997); *Yeager v. GMAC*, 719 So. 2d 210 (Ala. 1998); *Spina v. Toyota Motor Credit Corp.*, 703 N.E.2d 484 (Ill. App. Ct. 1998); *Rosen v. PRIMUS Auto. Fin. Servs.*, 618 N.W.2d 606 (Minn. Ct. App. 2000); *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. 1999); *Doe v. GMAC*, 635 N.W.2d 7 (Wis. Ct. App. 2001).

6. *See infra* notes 51–55 and accompanying text.

7. The disappointed tenant might have a cause of action for conversion, but this will not protect it from the landlord's trustee in bankruptcy. Under 11 U.S.C. § 507(a)(7) (amended 2013), an individual that makes a deposit in connection with the lease of property for “personal, family, or household use” but does not obtain the return of the deposit has a seventh-level priority unsecured claim for up to \$2,775, but priority at this level provides little real protection.

8. Article 9 defines “collateral” as “the property subject to a security interest.” U.C.C. § 9-102(a)(12) (2012 Official Text).

attach those funds might be subordinate to the landlord's obligation to return the funds to the tenant upon satisfactory completion of its lease obligations.⁹

A tenant may also justifiably expect that security-deposit funds will be held in a segregated bank account and not commingled with the landlord's own funds (which might increase the risk that the funds would be misappropriated or subject to payment to other creditors). If the tenant retains no property right in the funds, there are no common-law restrictions that would prevent the landlord from placing the funds in its operating account.¹⁰ By contrast, if the tenant's deposit is treated as Article 9 collateral subject to a possessory security interest in favor of the landlord, then Article 9's baseline rules¹¹ will govern the rights and responsibilities of the landlord with respect to those funds. These baseline rules require a secured party in possession of collateral to keep it identifiable, although fungible collateral may be commingled.¹²

Finally, the Article 9 baseline rules provide that if a secured party has possession or control of collateral and receives a monetary return on that collateral, the secured party must either apply this return against the debt or pay it to the debtor, unless the parties' agreement expressly provides otherwise.¹³ Thus, suppose that a landlord places the tenant's security deposit in an interest-bearing account and that the deposit earns a total of \$25 of inter-

9. It is conceivable that a landlord might improperly transfer security-deposit funds to a transferee that would take free of a tenant's interest in the deposited funds by virtue of the negotiability of those funds. The degree to which a particular transferee might take free of a tenant's interest in deposited funds is beyond the scope of this article.

10. In some states, the landlord has statutory obligations with respect to the handling of tenant security deposits. For further discussion, see *infra* notes 61–63 and accompanying text.

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. Because the term “default” has its own distinct significance in the Article 9 context, this article uses the term “baseline rule” rather than “default rule.”

12. U.C.C. § 9-207(b)(3) (2012 Official Text) (“[I]f a secured party has possession of collateral . . . the secured party shall keep the collateral identifiable, but fungible collateral may be commingled. . . .”). Thus, a landlord holding tenant security deposits could commingle those deposits within a segregated account holding only tenant security deposits.

13. The 1972 Official Text of Article 9 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.* § 9-207(2)(c) (1972 Official Text). As revised in 1998, Article 9 articulated the 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.” *Id.* § 9-207(c)(2) (2012 Official Text). The revised provision does not contain the “unless otherwise agreed” language used in the 1972 text. Nevertheless, the comments to section 9-207(c) make clear that the quoted language merely establishes “rules following common-law precedents which apply *unless the parties otherwise agree.*” *Id.* § 9-207 cmt. 3 (emphasis supplied).

est during the lease term. If the security deposit is Article 9 collateral, then the landlord must either apply that \$25 to reduce the tenant's lease obligation or pay it to the tenant, unless the parties have contracted out of Article 9's baseline rules through contrary lease provisions¹⁴ (subject to the possibility that some other positive law might require payment of interest on the deposit).¹⁵ By contrast, if the deposit belongs solely to the landlord and the tenant holds only a debt claim, the landlord need not pay interest earned on the security deposit to the tenant absent an express statutory obligation or a contrary contractual agreement.

At present, the Uniform Law Commission is revising the venerable Uniform Residential Landlord and Tenant Act (URLTA). Originally promulgated in 1972, URLTA has been adopted in whole or in significant part in 21 states.¹⁶ While the original URLTA imposes a limit on the size of a ten-

14. As discussed in the text accompanying notes 56–58 *infra*, Article 9 does not impose on the secured party any affirmative obligation to invest collateral in its possession or control so as to earn a monetary return. It merely requires that the secured party account for any monetary return actually received, unless the parties have contracted otherwise. U.C.C. § 9-207(c)(2) (2012 Official Text).

15. 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 to the lessee interest upon the lessee's security deposit. See *infra* note 57 for a list of state statutes requiring landlords to pay interest upon tenant security deposits.

In the consumer lease context, few existing state statutes expressly address the interest-on-security-deposit question. Illinois requires a consumer lessor to place a 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 (2012). 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 2013). 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 the security deposit. WIS. STAT. ANN. § 429.203(9) (2011–12).

In 2001, the Uniform Law Commission 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. UNIF. CONSUMER LEASES ACT § 303(d) (2001).

16. See *Legislative Fact Sheet—Residential Landlord and Tenant Act*, UNIF. LAW COMM'N, <http://uniformlaws.org/LegislativeFactSheet.aspx?title=Residential%20Landlord%20and%20Tenant%20Act> (last visited Oct. 14, 2013) (noting adoptions in Alabama, Alaska, Arizona, Connecticut, Florida, Hawaii, Iowa, Kansas, Kentucky, Michigan, Mississippi, Montana, Nebraska, New Mexico, Oklahoma, Oregon, Rhode Island, South Carolina, Tennessee, Virginia, and Washington).

ant security deposit¹⁷ and addresses the landlord's obligation to refund the deposit and justify any amount withheld,¹⁸ it neither explicitly addresses the characterization of the deposit nor the landlord's obligations, if any, with respect to the handling of the deposit. The revision of URLTA provides an excellent opportunity for the ULC to reconsider the issue of the proper characterization and handling of tenant security deposits.

This Article seeks to assist in that reconsideration. In Part I, we highlight two opinions representative of the majority of case decisions that have treated lessee security deposits as a "debt."¹⁹ These decisions rest upon a flawed understanding of Article 9's scope provisions, and wrongly conclude that Article 9 incorporated the "debt-pledge" distinction and excluded security deposits from its scope. These decisions exalt form over substance to a level that one cannot reconcile with Article 9's scope provisions—the interpretation of which is properly guided by economic substance rather than form.²⁰ For this reason, courts should recognize tenant security deposits as Article 9 security interests.²¹ In Part II, we briefly explore the extent to which Article 9's existing provisions appropriately address tenant security deposits, focusing particularly upon some potentially troubling differences that may follow if a security deposit is not made with property of the debtor (such as cash or a check) but is instead made with a credit card or similar payment mechanism.²² Part III argues that instead of attempting to modify Article 9 to more aptly govern tenant security deposits, the Uniform Law Commission should incorporate explicit provisions for the characterization and handling of tenant security deposits into the revised URLTA—provisions that acknowledge the security deposit as a form of secured transaction, but that address the expectations of residential landlords and tenants more appropriately than the existing provisions of Article 9. Part III con-

17. UNIF. RESIDENTIAL LANDLORD & TENANT ACT § 2.101(a) (1972) (amended 1974) ("A landlord may not demand or receive security, however denominated, in an amount or value in excess of [1] month[s] periodic rent." (brackets in original)).

18. *Id.* § 2.101(b) ("Upon termination of the tenancy property or money held by the landlord as security may be applied to the payment of accrued rent and the amount of damages which the landlord has suffered by reason of the tenant's noncompliance with [tenant's obligations] all as itemized by the landlord in a written notice delivered to the tenant together with the amount due [14] days after termination of the tenancy and delivery of possession and demand by the tenant."); *id.* § 2.101(c) ("If the landlord fails to comply with subsection (b) or if he fails to return any prepaid rent required to be paid to the tenants under this Act the tenant may recover the property and money due him together with damages in an amount equal to [twice] the amount wrongfully withheld and reasonable attorney's fees." (brackets in original)).

19. See *infra* notes 30–47 and accompanying text.

20. See *infra* notes 48–73 and accompanying text.

21. See *infra* notes 74–86 and accompanying text.

22. See *infra* notes 87–124 and accompanying text.

cludes with statutory language proposed for inclusion within the revised URLTA.²³

II. SECURITY DEPOSITS, THE “DEBT-PLEDGE” DISTINCTION, AND THE PROPER SCOPE OF ARTICLE 9

As discussed in the introduction, the weight of authority in the Article 9 era has concluded that Article 9 does not apply to security deposits.²⁴ Many of the decisions merely rely upon earlier opinions in other states, without undertaking significant independent analysis. Rather than summarize all of the decisions, Part IA looks in some detail at two of these decisions—*Knight v. Ford Motor Credit Co.*²⁵ from the Ohio Court of Appeals and *Yeager v. GMAC*²⁶ from the Alabama Supreme Court—and the justification offered by these courts for excluding security deposits from the scope of Article 9.²⁷ Part IB critiques these decisions, demonstrating how the courts inappropriately relied upon the “debt-pledge” distinction to exclude security deposits from Article 9’s scope.²⁸ Part IB further demonstrates that given the reasonable expectations of the typical parties to a residential lease and the broad scope provisions of Article 9, there is no functional reason for courts to exclude tenant security deposits from Article 9’s coverage.²⁹

A. Two Representative “Security Deposit as Debt” Cases

The first of the representative security-deposit cases is *Knight v. Ford Motor Credit Co.*,³⁰ which involved the 1995 lease of a Ford Windstar by Michael Knight. Pursuant to a lease that the initial lessor assigned to Ford Motor Credit Company (“Ford”), Knight paid a \$225 security deposit.³¹ At the conclusion of the lease term, Knight sued to recover the interest Ford had earned on his security deposit and sought class certification on behalf of similarly situated lessees. Knight argued that the security deposit was personal property belonging to him and that it secured payment or performance of his lease obligations; thus, he argued that the deposit was “a security in-

23. See *infra* notes 125–142 and accompanying text.

24. See cases cited *supra* note 5.

25. 735 N.E.2d 513 (Ohio Ct. App. 2000).

26. 719 So. 2d 210 (Ala. 1998).

27. See *infra* notes 30–47 and accompanying text.

28. See *infra* notes 48–58 and accompanying text.

29. See *infra* notes 59–86 and accompanying text.

30. 735 N.E.2d 513 (Ohio Ct. App. 2000).

31. *Id.* at 514. Knight did not actually pay this amount by cash or check; instead, he received a credit for the sum of \$225 based upon the stipulated value of his trade-in vehicle. *Id.*

terest under Ohio law” and that section 9-207(c) governed Ford’s responsibilities with respect to that deposit.³²

The trial court rejected Knight’s argument and granted summary judgment for Ford. Relying extensively upon the weight of prior decisions in other states, the Ohio Court of Appeals affirmed, holding that the security deposit created merely a “debt.” 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.”³³ In support of this conclusion, 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”³⁴ and that in such a relationship “there is no implied obligation to pay interest on the deposit.”³⁵ The *Knight* court reasoned that this principle was so well-established that Article 9’s drafters must have intended to preserve it in enacting section 9-207. The court concluded that if the Ohio legislature had intended to obligate lessors to pay 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 [UCC § 9-207(c)]. 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.³⁶

The second representative decision is *Yeager v. GMAC*.³⁷ In May 1995, Richard Yeager leased an automobile from Solomon Chevrolet (“Solomon”) under a lease assigned to GMAC. Yeager made a security deposit of \$350 pursuant to paragraph 29 of the lease, which provided in pertinent part:

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.

32. *Id.* at 516.

33. *Id.* at 517.

34. 2 MILTON R. FRIEDMAN, *FRIEDMAN ON LEASES* § 20.4, at 1291 (Practising Law Institute, 4th ed. 1997).

35. *Id.* at 1292.

36. *Knight*, 735 N.E.2d at 516 (citing OHIO REV. CODE ANN. § 5321.16 (West 1995) (requiring interest on real property lease security deposits in certain conditions); *id.* § 3733.18 (requiring interest on manufactured home park and marina rental security deposits)).

37. 719 So. 2d 210 (Ala. 1998).

After the end of this Lease, we will refund to you any part of the security deposit that is left.³⁸

The following year, 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. 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, and that the deposit thus constituted a possessory security interest in Yeager's money. Yeager argued that section 9-207 thus obligated GMAC to remit to Yeager (or apply to Yeager's lease obligations) any money "received from the collateral."³⁹ GMAC and Solomon argued that although the lease characterized the funds as a "deposit" subject to "refund,"⁴⁰ the lease actually transferred outright ownership such that Yeager retained no legal interest in the deposited funds.⁴¹ According to GMAC and Solomon, the deposit created only a "debt," not a "pledge of collateral"; thus, section 9-207 did not govern their rights and responsibilities with respect to the deposit, and they had no obligation under Alabama common law to pay interest on a security deposit.⁴² The trial court granted summary judgment to GMAC and Solomon, and the Alabama Supreme Court unanimously affirmed.⁴³

In contrast to *Knight*—which, like most of the security-deposit cases, concluded as a matter of law that Article 9 did not apply to a lease security deposit—*Yeager* 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.⁴⁴ 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., Inc.*,⁴⁵ where the court held that section 9-207 governed reserve accounts held on deposit by GECC under a retail financing agreement.⁴⁶ Nevertheless, *Yeager* distinguished *Alford* on the merits—

38. *Id.* 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.

39. *Id.* at 211.

40. See *id.* at 210.

41. *Id.* at 211 ("[Yeager] 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. *Id.* at 210–11.

43. *Yeager*, 719 So. 2d at 213.

44. *Id.* at 212–13.

45. 374 So. 2d 1316 (Ala. 1979).

46. The plaintiff in *Alford* operated a mobile home sales business for which General Electric Credit Corp. ("GECC") provided both wholesale and retail financing. *Id.* at 1318–20. The retail financing agreement provided that GECC could establish "a time sales security

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.*⁴⁷

The *Yeager* court thus concluded that section 9-207 did not apply to Yeager’s security deposit, and that neither GMAC nor Solomon had any positive obligation to pay interest on the deposit.

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. Both decisions 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 only a “debt” (to which Article 9 does not apply). There are three problems with this conclusion. First, the courts misunderstood the context in which the pledge/debt distinction developed, and thus misapplied the distinction to the facts of the dispute.⁴⁸ Second, uncritical acceptance of the “debt-pledge” distinction has discouraged courts from engaging in serious economic analysis of whether the “no-interest-on-security-deposits” rule remains an appropriate baseline rule in interpreting consumer leases.⁴⁹ Third (and perhaps most significantly), regardless of the status of the pledge/debt

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.* at 1320–21. 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 obligated GECC to account to Alford for profits earned on the reserve accounts. *Id.* at 1322–23.

47. *Yeager*, 719 So. 2d at 213 (alteration in original) (emphasis added).

48. See *infra* notes 51–58 and accompanying text.

49. See *infra* notes 59–65 and accompanying text.

distinction under landlord-tenant law, the distinction became irrelevant within the framework of Article 9 once the plain terms of Article 9 swept security deposits within its scope.⁵⁰

1. *The Historical Origins of the Pledge/Debt Distinction.*

There is a substantial body of pre-Code law that holds that a security deposit creates merely a debt as distinguished from a pledge. Yet 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.”

A few courts treated security deposits as presumptively establishing a trust, with the landlord’s responsibilities for the handling the deposit being 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 to invest the deposit for the tenant’s benefit, and would hold the landlord liable for its failure to do so. Because leases typically did not establish an express trust relationship regarding the security deposit—and given the understandable reluctance to view the landlord-tenant relationship as fiduciary in nature—very few common-law decisions (predominantly New York courts) characterized a security deposit as a trust.⁵¹

50. See *infra* notes 66–86 and accompanying text. See also U.C.C. § 9-202 (provisions of Article 9 with regard to rights and obligations apply whether title to collateral is in debtor or secured party) and the explanation of the section in note 102 *infra*.

51. 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 34 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 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 (2006); N.H. REV. STAT. ANN. § 540-A:6 (2006); N.J. STAT. ANN. § 46:8–19 (West 2004); N.Y. GEN. OBLIG. LAW § 7-103 (McKinney 2013); S.C. CODE ANN. § 27-40-210 (2012). Numerous other states have enacted statutes that create a similar relationship without specifically denominating the relationship as a “trust.” See, e.g., CONN.

Alternatively, a slightly larger number of courts treated a security deposit as a “pledge” of the tenant’s property—with the landlord’s responsibilities for the deposit being governed by the common law relating to pledges. Under this view, advanced principally in New Jersey and California decisions,⁵² the landlord could legally commingle the deposit with its own operating funds, and was under no positive duty to invest the deposit on the tenant’s behalf. Still, the landlord could not permanently dispose of the deposit, at least for a reason unrelated to the tenant’s lease obligations. Further, though the landlord had no duty to invest the deposit on the tenant’s behalf, any return that the landlord did earn on the deposit was considered the tenant’s property.⁵³

Rather than characterize a security deposit as a “trust” or a “pledge,” however, most courts resolving landlord-tenant disputes merely characterized the deposit as a “debt.” Under this view, the landlord had no duty to invest the deposit on the tenant’s behalf. Title to the deposited funds passed to the landlord as soon as the tenant made the deposit. The landlord could commingle the deposit with the landlord’s other funds and use the deposited funds as it wished without liability to the tenant; further, the landlord could retain any interest actually earned on the deposit. The tenant retained no interest in the money at all, but held merely a contractual claim against the landlord for reimbursement.⁵⁴ 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.⁵⁵ By characterizing the deposit as a “debt,” courts vindicated the standard commercial practices of landlords—in a fashion that gave lip service to the “presumed” intention of both landlord and tenant.

With this background in view, the first problem with the security-deposit cases becomes apparent. The court in *Knight* assumed that if it had

GEN. STAT. ANN § 47a-21 (West 2012); DEL. CODE ANN. tit. 25, § 5514(b) (West 2013); MD. CODE ANN., REAL PROP. § 8-203 (2006); MASS. GEN. LAWS ANN. ch. 186, § 15B (2005); N.D. CENT. CODE § 47-16-07.1 (2009).

52. Partington v. Miller, 5 A.2d 468, 471 (N.J. 1939); Cummings v. Freehold Trust Co., 191 A. 782, 783 (N.J. 1937); Boteler v. Koulouris, 37 P.2d 136, 137 (Cal. Dist. Ct. App. 1934). See also Harris, *supra* note 51, at 416–21.

53. Ingram v. Pantages, 86 Cal. Ct. App. 41, 44–45, 260 P. 395, 396 (1927). 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 (section 9-207 reflects “evident intent of codifying the common law [regarding pledgor-pledgee relationship] without substantial change”).

54. For a summary of cases adopting this view, see Harris, *supra* note 51, at 413–16.

55. 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.”).

characterized Knight's deposit as a "pledge"—*i.e.*, if it had ruled that UCC section 9-207 governed the deposit—it would have reversed the common-law principle that landlords had no positive obligation to pay interest on security deposits absent express agreement. But this assumption is incorrect; the *Knight* court erroneously conflated two entirely different questions. Whether a lessor's security deposit constitutes an Article 9 security interest is a separate question from whether the lessor is obligated to pay interest on that deposit. Characterizing the lessor's security deposit as an Article 9 security interest (the effective equivalent of a common-law "pledge") would not *by itself* have reversed the common law principle that a landlord had no positive obligation to invest a security deposit for the tenant's account. A pledgee had no such obligation under common law, and section 9-207(c) codified pre-Code law governing the pledgor-pledgee relationship.⁵⁶ Section 9-207(c) does not obligate a party holding funds as security to invest them in an interest-bearing account in the absence of an express contractual obligation to do so. If courts rule that Article 9 governs a security deposit, the lessor would have to pay interest to the lessee only if (a) the lease or other positive law expressly so required⁵⁷ or (b) the lessor actually earned a return

56. GILMORE, *supra* note 53 at 1128 (section 9-207 reflects "evident intent of codifying the common law [regarding pledgor-pledgee relationship] without substantial change").

57. In the landlord-tenant context, a significant number of state legislatures have imposed on landlords a positive duty to pay interest upon security deposits. *See, e.g.*, ARIZ. REV. STAT. ANN. § 33-1431(B) (2000) (mobile home landlords) (5% annual interest); CONN. GEN. STAT. ANN. § 47a-21 (2012) (average rate of insured savings institutions); 765 ILL. COMP. STAT. 715/1 (2013) (passbook savings rate of state's largest commercial bank on deposits held longer than six months); ME. REV. STAT. ANN. tit. 10, § 9098 (1997) (mobile home landlords) (interest earned or "reasonable" rate, defined as "interest calculated at the Federal Reserve Bank, secondary market, annual interest rate on a 6-month certificate of deposit for each year in which the deposit has been held calculated as of the first business day of each year"); MD. REAL PROP. CODE ANN. § 8-203 (West 2006) (3% simple interest); MASS. GEN. LAWS ANN. ch. 186, § 15B(3)(b) (2005) (5%, or actual interest earned if less, on deposits held one year or longer); MINN. STAT. ANN. § 504B.178(2) (2010) (1% simple interest); N.H. REV. STAT. ANN. § 540-A:6 (2006) (rate paid on savings accounts at institution holding the deposit, on deposits held one year or longer); N.J. STAT. ANN. § 46:8-19 (West 2004) (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 2013) (same); N.D. CENT. CODE § 47-16-07.1 (2009) (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) (West 2013) (5% on deposits exceeding \$50 or one month's periodic rent, where tenant remains in possession for six months or longer); 68 PA. CONSOL. STAT. § 250.511b (2013) (landlord must pay interest on deposits held for more than two years, less 1% administrative fee); VA. CODE ANN. § 55-248.15:1(B) (2013) (4% 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% simple interest or 75% of the interest actually earned by the deposits. FLA. STAT. ANN. § 83.49(1) (West 2013).

on the deposit and the lease did not expressly disclaim an obligation to pay those earnings to the lessee. The courts deciding the security deposit cases could have reached this result 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.⁵⁸

2. *What Is the Reasonable Understanding of the Term “Security Deposit”?*

As discussed above, while the security-deposit cases pay lip service to presumed intent, there is reason to doubt that characterizing a security deposit as merely a “debt” reflects the shared understanding of the reasonable landlord and tenant. The “debt” characterization is most obviously betrayed by the parties’ own terminology—they label the transaction as a “security deposit.” The “debt” characterization requires a presumption that the reasonable tenant understands and agrees that: (a) the tenant will have no property right in the deposited funds once paid to the landlord; (b) the tenant will have no priority right in the funds against the landlord’s other creditors unless other positive law grants such a right; (c) the landlord may use the funds as it wishes absent other positive law to the contrary; and (d) any return on

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) (2013) (mobile home landlords) (interest earned on deposit may be retained by landlord as compensation for administering deposit); IOWA CODE § 562A.12(2) (2013) (interest earned on deposit during first five years constitutes property of landlord); KAN. STAT. ANN. § 58-25.108(b) (mobile home landlords) (interest earned on deposit constitutes property of landlord); N.M. STAT. ANN. § 47-10-10(B) (2013) (mobile home landlords) (interest earned on deposit may be retained by landlord as compensation for administering deposit); OKLA. STAT. tit. 41, § 115(B) (2013) (landlord may return deposit “without interest”); WASH. REV. CODE ANN. § 59.18.270 (2011) (landlord need not pay interest earned on security deposits absent contrary written agreement); WASH. REV. CODE ANN. § 59.20.170 (2013) (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) (2013); CAL. CIV. CODE § 1950.5(d) (West 2013); DEL. CODE ANN. tit. 25, § 5514(b) (2013); GA. CODE ANN. § 44-7-31 (2006); HAW. REV. STAT. § 521-44(b) (2013); OR. REV. STAT. ANN. § 90.300(2) (2012); S.C. CODE ANN. § 27-40-210 (2012); TENN. CODE ANN. § 66-28-301(a) (2012). Presumably, under the existing common law rules, these statutes would obligate landlords to pay interest on security deposit if courts in those states interpreted the statutes to establish an actual trust relationship between landlord and tenant with respect to the deposit.

58. As explored *infra* notes 59–65 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.

the deposited funds belongs to the landlord. Essentially, the transaction contemplated by the “debt” characterization is an *interest-free loan from the tenant to the landlord*. But the parties do not call the deposit an “interest-free loan.” They call it “security”—and that label is consistent with the tenant’s expectations regarding the purpose and use of the funds.

Courts in the security-deposit cases have uncritically accepted that the traditional common-law rule (*i.e.*, no interest on security deposits unless the lease expressly so provides) provides an appropriate baseline rule. But there is little reason to view this as an appropriate “gap-filling” rule, or to conclude that Article 9’s drafters viewed it as such. In a hypothetical “one landlord vs. one tenant” negotiation, the lessee might well forgo a claim to interest on the deposit if the lessor’s administrative costs of investment, record-keeping, and reimbursement would exceed the interest actually earned on the deposit. Otherwise, the lessee might have to bear the higher rent that the lessor would demand to carry the duty to pay interest.⁵⁹ But most commercial landlords negotiate with hundreds or thousands of tenants, and economies of scale reduce the lessor’s administrative costs dramatically on a per-lessee basis. The lessor’s total costs may well be less than the total interest the lessor could accrue on all aggregated security deposits. If individual lessees could organize and bargain collectively, a reasonable lessor might be compelled to agree to pay interest on security deposits, or to accept lessee demands for rent concessions to offset the forgone interest.

In the real world, of course, lessees negotiate leases individually, and no individual lessee has a sufficient financial incentive to negotiate for and obtain the lessor’s general commitment to pay interest on all 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 behalf of diffuse lessees, accomplishing the bargain that unimpeded collective bargaining presumptively would have produced.⁶⁰

The traditional argument also assumes equality of bargaining power between lessors and lessees—an assumption that is largely false in the context of consumer/residential 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

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

60. See, e.g., 765 ILL. COMP. STAT. 715/1 (2013) (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 2004) (landlord with ten or more units obligated to pay interest on deposits); N.Y. GEN. OBLIG. LAW § 7-103 (McKinney 2013) (landlord with six or more units obligated to pay interest on deposits).

argument, one might expect that market forces would compel the lessor to accept a slight rent concession to avoid incurring 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.

In recent years, many states in fact have recognized that a landlord's commingling and use of a tenant's security deposit for the landlord's own account violates the reasonable expectations of the typical residential tenant. Further, they have acknowledged that residential tenants lack the bargaining power needed to negotiate meaningful constraints on the landlord's handling of deposits. 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 the tenant or to segregate it from other funds,⁶¹ and some have chosen to make these regulations nonwaivable.⁶² Some of these statutes further impose upon the landlord an affirmative obligation to pay interest on the deposit.⁶³

One might take two different views of these state statutes. One might view them as a policy-based rejection of contrary common law principles, driven by real or perceived bargaining power inequalities and implemented to constrain rent-seeking behavior by landlords. 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.⁶⁴ Alternatively, one might treat such statutes as recognizing the hypo-

61. See, e.g., ALASKA STAT. § 34.03.070(c) (2013); COLO. REV. STAT. § 38-12-209(2)(b) (2013) (mobile home parks); CONN. GEN. STAT. ANN. § 47a-21 (West 2012); DEL. CODE ANN. tit. 25, § 5514(b) (2013); FLA. STAT. ANN. § 83.49(1) (West 2013); GA. CODE ANN. § 44-7-31 (2006); IOWA CODE § 562A.12(2) (2013); KAN. STAT. ANN. § 58-25,108(b) (2013) (mobile home parks); MD. REAL PROP. CODE ANN. § 8-203(d) (West 2013); MASS. GEN. LAWS ANN. ch. 186, § 15B (2005); N.H. REV. STAT. ANN. § 540-A:6 (2006); N.J. STAT. ANN. § 46:8-19 (West 2004); N.M. STAT. ANN. § 47-10-10(B) (2013) (mobile home parks); N.Y. GEN. OBLIG. LAW § 7-103(3) (McKinney 2013); N.Y. REAL PROP. LAW § 233(4) (McKinney 2009) (mobile home parks); N.C. GEN. STAT. § 42-50; N.D. CENT. CODE § 47-16-07.1 (2013); OKLA. STAT. tit. 41, § 115(A) (2013); 68 PA. CONSOL. STAT. § 250.511b (2013); TENN. CODE ANN. § 66-28-301(a) (2012); WASH. REV. CODE ANN. § 59.18.270 (West 2012); WASH. REV. CODE ANN. § 59.20.170 (West 2013) (mobile home parks).

62. See, e.g., CONN. GEN. STAT. ANN. § 47a-4(a)(4) (West 2013) (lease cannot disclaim landlord's obligation to pay interest on deposit); MD. CODE ANN. REAL PROP. § 8-203(j) (West 2013) (same); N.H. REV. STAT. ANN. § 540-A:8(III) (2013) (same).

63. For a comprehensive list of these statutory provisions, see *supra* note 57.

64. See, e.g., *Korens v. R.W. Zukin Corp.*, 212 Cal. App. 3d 1054, 1058, 261 Cal. Rptr. 137, 139 (1989) (refusing to create judicial rule "requiring the payment of interest on security deposits when the legislature has declined to do so") (citing Suzette Clover, Comment, *Interest On Security Deposits—Benefit or Burden To Tenant?*, 26 UCLA L. REV. 396, 399–400 (1978)).

thetical 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 has played in transforming the landlord-tenant relationship.⁶⁵

3. *Focusing Properly on Article 9's Scope Provisions*

More fundamentally, the security deposit cases simply disregard Article 9's scope provisions. After the adoption of Article 9, the common law's historical pledge/debt dichotomy as articulated in pre-Code landlord-tenant cases became irrelevant. Even if a security deposit creates a debt owing from the lessor to the lessee, that premise does not lead to a conclusion that the security deposit is not an Article 9 security interest. If the lessor holds a deposit as security for the lessee's obligations, the deposit creates both a "debt" (to the extent that the landlord is obligated to repay the funds) and an Article 9 "security interest" in the deposit.

As at least one of the security-deposit cases conceded,⁶⁶ one cannot reconcile decisions like *Knight* and *Yeager* with the breadth of Article 9's scope provisions. The world of 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 or should not be governed by Article 9 is irrelevant.⁶⁷ As we have explained

65. 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.,* *Schneiker v. Gordon*, 732 P.2d 603 (Colo. 1987) (obligating landlord to mitigate loss caused by tenant's abandonment of premises); *Pugh v. Holmes*, 405 A.2d 897 (Pa. 1979) (adopting implied warranty of habitability). *See generally* Charles J. Goetz, *Wherefore the Landlord-Tenant Law "Revolution"?—Some Comments*, 69 CORNELL L. REV. 592 (1984).

66. *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].").

67. *See* U.C.C. § 9-109 cmt. 2, which states, "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. Likewise, the subjective intention of the parties with respect to the legal characterization of their transaction is irrelevant to whether this Article applies, as it was to the application of former Article 9 under the proper interpretation of former Section 9-102." The latter sentence

elsewhere, “[w]ith parties sometimes disposed to disguise the true nature of their transactions, courts cannot simply accept their expressions of intention as controlling.”⁶⁸ 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 intention, unless Article 9 expressly excludes that transaction from its scope.

Both the text of Article 9 and its comments contemplate that parties can create a security interest in money.⁶⁹ Thus, if one party requires another party to deposit money to secure the depositor’s payment or performance obligations to the donee, a security interest in money arises unless Article 9’s scope provisions explicitly exclude that transaction. Yet Article 9’s scope provisions contain no express exclusion for security deposits.⁷⁰ Furthermore, a security deposit serves the exact same economic function as a possessory security interest in money. If the security-deposit cases are correct, any party using funds to secure payment or performance of an obligation could opt out of Article 9 altogether simply by calling the transfer of the funds a “security deposit.” 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

was added to the comment in 2010 to emphasize what had always been the correct interpretation of the requirement that security interests arise from contracts.

68. WILLIAM H. LAWRENCE, WILLIAM H. HENNING & R. WILSON FREYERMUTH, UNDERSTANDING SECURED TRANSACTIONS § 1.03[A], at 12 (5th ed. 2012). Section 1-201(b)(35)’s definition of “security interest” makes this explicit in authorizing courts to recharacterize as a “security interest,” in appropriate cases, a transaction that the parties themselves labeled as a “lease.” U.C.C. § 1-203 (2012 Official Text).

69. See U.C.C. § 9-313(a) (2012 Official Text) (“[A] secured party may perfect a security interest in . . . money . . . by taking possession of the collateral.”); *id.* § 9-332(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.* § 9-313 cmt. 2 (“[Section 9-313] permits a security interest to be perfected by the taking of possession only when the collateral is goods, instruments, tangible negotiable documents, money, or tangible chattel paper”); *id.* § 9-310 cmt. 2 (“[F]iling ordinarily [does not] perfect a security interest in . . . money”); *id.* § 9-315 cmt. 2 (“Section 9-332 enables . . . most transferees of money to take free of a perfected security interest in the . . . money.”).

70. *Id.* § 9-109(d). Article 9 does exclude “a landlord’s lien” from Article 9, U.C.C. § 9-109(d)(1), as well as “the creation or transfer of an interest in or lien on real property, including a lease,” *id.* § 9-109(d)(11). However, the comments make clear that this exclusion applies to “interests in or liens on real property” and that these exclusions merely “reiterate the limitations on coverage (*i.e.*, ‘by contract,’ ‘in personal property and fixtures’) made explicit in [Section 9-109(a)(1)’s general scope provision].” *Id.* § 9-109 cmt. 10. Neither of these sections would thus exclude a security deposit from Article 9’s scope.

most certainly should not interpret Article 9's scope provisions to make it so.

Further, section 303 of the Uniform Consumer Leases Act (UCLA) 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.”⁷¹ Section 303(b) then provides that a consumer lease “may provide for . . . a security deposit.”⁷² 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—UCLA essentially recognizes that a security deposit in a consumer lease is an Article 9 security interest.⁷³

4. *Conclusion*

Even if courts properly treated security deposits as Article 9 security interests, most existing lease transactions would not render lessors and/or assignees liable for interest on security deposits unless the state's statute obligated the payment of interest. Absent such a statute, the landlord can (and typically does) ensure that its lease provides no obligation to invest the funds on the tenant's behalf or to pay the tenant interest on the deposit. As a result, there is no functional reason for courts to interpret Article 9 to exclude lease security deposits from its scope.⁷⁴

71. UNIF. CONSUMER LEASES ACT § 303(a) (2001). The UCLA defines the term “security interest” to have the identical meaning as the same term under the UCC. *Id.* § 102(b)(9).

72. *Id.* § 303(b)(1).

73. UNIF. CONSUMER CREDIT CODE (UCCC) § 3.301(2) (1974) 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 (2012); IOWA CODE § 537.3301(2) (2013); S.C. CODE ANN. § 37-2-407(2) (2002); WIS. STAT. § 422.417(2) (2011–2012); WYO. STAT. ANN. § 40-14-241(b) (2013).

74. 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. § 9-610(b) (2012 Official Text), 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. *See id.* § 9-611(d).

In his work on the interpretive challenges presented by drafting errors within Article 9,⁷⁵ 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;⁷⁶ (2) courts should establish a presumption of codification, not revision;⁷⁷ (3) courts should recognize that the Code establishes mostly baseline rules;⁷⁸ (4) courts should appreciate the need for uniformity;⁷⁹ and (5) courts should adopt inclusive approaches to scope questions.⁸⁰ Considering these guidelines confirms the lack of any functional justification for courts to interpret Article 9 as excluding security deposits. Guidelines (1) and (5) most clearly argue for inclusion of the security deposit. Article 9's primary purpose was to consolidate the *mélange* of pre-Code security devices within the unitary conception of the "security interest,"⁸¹ and the Code clearly directs that courts should resolve scope-related issues by reference to economic substance rather than legal form or location of title.⁸² Plainly, courts should not permit the parties to "opt out" of Article 9's scope altogether merely by characterizing a security device as a "deposit."

75. 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.

76. *See id.* at 117. Section 1-103(a) directs that the Code "must be liberally construed and applied to promote its underlying purposes and policies." U.C.C. § 1-103(a) (2012 Official Text).

77. Maggs, *supra* note 75, at 117–18 ("Unless something indicates otherwise, courts should presume the drafters intended only to preserve the previous rule.").

78. *Id.* at 118 ("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.").

79. *Id.* at 119 ("Although courts do not have to follow UCC [sic] 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.").

80. *Id.* at 119–20.

81. *See, e.g.*, U.C.C. § 9-101 cmt. 1 (2012 Official Text); 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 9.1, at 288–90 (1965).

82. *See* U.C.C. § 9-202 cmt. 2 (2012 Official Text) (location of title irrelevant with respect to rights and responsibilities of parties to a secured transaction). The substance-over-form directive is most clearly demonstrated in section 1-203, which prevents avoiding the consequences of Article 9 merely by characterizing a security agreement as a "lease" governed by the common law of leasing. *See* U.C.C. § 1-203 cmt. 2 (2012 Official Text) (scope of "security interest" to be informed by "economics" rather than parties' subjective intent as manifested by formal labels).

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, it should be assumed that the drafters effectively codified that rule. But, as explained above,⁸³ such a conclusion is a *non sequitur*. Section 9-207(c) does not establish a baseline rule positively obligating a secured party to pay interest on money collateral held in its possession. Section 9-207(c) instead codified pre-Code rules governing pledges. Under these rules the pledgee had no duty to invest the collateral on the pledgor's behalf, but did have to account for the earnings if the collateral was invested. 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 sections 9-109(a)(1) and 1-201(b)(35) that are critical—and those sections thoroughly belie any conclusion that Article 9's drafters blindly accepted formal distinctions grounded in landlord-tenant law.⁸⁴

Likewise, guideline (3)—that the Code establishes principally baseline rules—does not justify excluding lease security deposits from Article 9's scope. One might argue, as the court essentially did 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.⁸⁵ Thus, excluding security deposits from Article 9 would save the parties from having to express this understanding explicitly or from having to bargain around a contrary result. By the same token, it hardly seems burdensome to obligate a lessor—who is almost inevitably the master of the lease form—to make such an understanding implicit in its contract. This is particularly appropriate to the extent that landlord practice in the consumer context may reflect more about bargaining power inequalities than the underlying shared understandings of the parties.⁸⁶ Moreover, excluding lease security deposits from Article 9 to validate a 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 sanctions such a practice.

83. See *supra* notes 56–58 and accompanying text.

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

85. See *supra* note 36 and accompanying text.

86. See *supra* notes 59–65 and accompanying text.

III. APPLICATION OF ARTICLE 9 (INCLUDING DISTINCTIONS BASED ON THE FORM IN WHICH A SECURITY DEPOSIT IS PAID)

Although Article 9 should generally be held to govern tenant security deposits, it was not drafted with security-deposit transactions in mind. As a result, interesting—and in some instances complex—problems arise in the application of its provisions. First and foremost is the problem of categorizing the collateral. Although we presume that the payment of a security deposit in cash is relatively rare, it might be easiest to explore the issues by starting with the analysis of a cash deposit and contrasting the analysis for check or credit-card deposits.⁸⁷

For purposes of the UCC, cash is “money,”⁸⁸ and a security interest in money may be perfected only by possession.⁸⁹ Although attachment can occur before the landlord takes possession of the money, the landlord cannot be certain of attachment until that time.⁹⁰ Because a landlord’s security interest in money is inevitably possessory in nature, attachment requires (other than the normal requirements that the secured party give value⁹¹ and that the debtor have rights or the power to transfer rights in the collateral⁹²) only that the secured party take possession pursuant to agreement.⁹³

The landlord will typically deposit the money in a bank account, and its right of withdrawal as a creditor of the bank constitutes proceeds of the money. We often think of proceeds as deriving from a disposition of collat-

87. In addition to cash, check, and credit card, a security deposit might be made using one of several other possible methods (e.g., debit card, wire transfer, stored-value card). Each of these methods is similar to a credit-card transaction in that the funds in the landlord’s account do not represent the proceeds of property of the debtor, and thus the analysis applicable to credit-card transactions should apply equally to transactions involving these mechanisms. Although we conclude that Article 9 should be held to apply to credit-card and similar transactions, there is a credible argument to the contrary.

88. U.C.C. § 1-201(b)(24) (2012 Official Text) (“‘money’ means a medium of exchange currently authorized or adopted by a domestic or foreign government.”).

89. *Id.* §§ 9-310(a), 9-312(b)(3), 9-313(a).

90. For attachment to occur before the landlord takes possession, the tenant would have to authenticate a security agreement describing the collateral. *Id.* § 9-203(b)(3)(A). *Id.* § 9-108(b)(4) provides that a description of collateral is legally sufficient if it identifies the collateral by quantity, and this would seem to apply, at least by analogy, to a reference to a sum certain in dollars. Attachment, however, would not occur unless the tenant had enough cash on hand to pay the deposit, and even then the cash on hand might be dissipated and other cash obtained before payment of the deposit (under U.C.C. § 9-332(a), a transferee of money takes free of a security interest in the money unless the transferee and the debtor collude to violate the rights of the secured party).

91. *Id.* § 9-203(b)(1).

92. *Id.* § 9-203(b)(2).

93. *Id.* § 9-203(b)(3)(B).

eral by a debtor, but revised Article 9 is not so limited.⁹⁴ Pre-revision Article 9 required that property be received by the debtor in order to qualify as proceeds,⁹⁵ but this requirement has been eliminated.⁹⁶

Assume for the moment that the bank account is dedicated to security deposits and that the landlord maintains records that enable it at any time to determine the amount of funds in the account attributable to each of its tenants. Because the landlord's records permit the proceeds to be identified notwithstanding the commingling of multiple tenant deposits, the security interest attaches to them.⁹⁷ In our opinion, the Article 9 collateral type for the proceeds is "deposit account,"⁹⁸ and because proceeds in a deposit account are "cash proceeds"⁹⁹ the landlord's security interest remains perfected.¹⁰⁰ If the landlord's records are insufficient to permit identification of the collateral, Article 9 permits the task to be accomplished by application of equitable tracing principles permitted under other law.¹⁰¹

There is an oddity in applying the identifiability requirement in the context of security deposits. If a debtor disposes of collateral and deposits the proceeds to its own deposit account, an inability to identify the proceeds harms the secured party, which loses its security interest and has nothing in

94. Although proceeds most commonly result from a disposition of collateral, there are a number of contexts in which there does not need to be a disposition for proceeds to be generated. *See, e.g.*, U.C.C. § 9-102(a)(64)(C) (2012 Official Text) (covering distributions, such as cash or stock dividends, distributed on account of collateral).

95. *Id.* § 9-306(2) (1997 Official Text).

96. It is doubtful whether the drafters of the revision had in mind a situation in which a secured party generates the proceeds. The comments explain that,

[w]hen collateral is sold subject to a security interest and the buyer then resells the collateral, a question arose under former Article 9 whether the "debtor" had "received" what the buyer received on resale and, therefore, whether those receipts were proceeds. . . . [Under revised Article 9] it is necessary only that the property be traceable, directly or indirectly, to the original collateral.

Id. § 9-102 cmt. 13(d) (2012 Official Text).

97. *Id.* §§ 9-203(f), 9-315(a)(2).

98. *Id.* § 9-102(a)(29). A more common situation in which a deposit account constitutes collateral involves a debtor assigning an entire account; and in the transaction under discussion, the landlord's security interest in each tenant's security deposit represents only a portion of the funds in the account. Nevertheless, the landlord's interest is properly classified as a deposit account; otherwise it would constitute a general intangible as to which perfection would require the filing of a financing statement, an absurd result when the secured party is in control. *Cf. Id.* § 9-102 cmt. 5(d) (lessor's assignment of right to lease payments separate from its rights in leased goods constitutes assignment of chattel paper).

99. *Id.* § 9-102(a)(9) ("Cash proceeds" means proceeds that are money, checks, deposit accounts or the like.)

100. U.C.C. § 9-315(c), (d)(2) (2012 Official Text) (providing that if security interest in original collateral is perfected, security interest in identifiable cash proceeds is perfected).

101. *Id.* § 9-315(b)(2). "Among the 'equitable principles' whose use other law may permit is the 'lowest intermediate balance rule.'" *Id.* § 9-315 cmt. 3. For more information on the lowest intermediate balance rule, *see* RESTATEMENT (SECOND) OF TRUSTS § 202 (1959).

its possession or control to make up for the loss. By contrast, if proceeds are in a deposit account controlled by a landlord, an inability to identify the proceeds does not deprive the landlord of them; rather, it would seem to convert the landlord's security interest into an ownership interest.¹⁰² This leaves the tenant, who until the loss of identification owns the funds (or, if title has already passed to the landlord, has a property right in the funds) with a mere right of reimbursement that will most likely be partially or entirely discharged if the landlord files a petition in bankruptcy.¹⁰³ Perhaps the best result in this situation would be to relax the identification standards to the extent possible for a tenant entitled to a return of its deposit, but maintain the normal standards for a landlord seeking to assert its perfected status against a tenant's bankruptcy trustee.

A defect of Article 9 in this context is that it does not explicitly require the landlord to maintain the identifiability of funds on deposit. In the case of collateral in a secured party's possession, Section 9-207(a) requires the secured party to use reasonable care in the custody and preservation of the collateral. Section 9-207(b)(3), also applicable to collateral in the possession of a secured party, requires the secured party to maintain the identifiability of the collateral but permits fungible collateral to be commingled. As to funds on deposit, a landlord has control rather than possession and thus the requirements of Sections 9-207(a) and (b) do not apply. Section 9-207(c), which applies when a secured party has either possession or control, does not contain parallel rules. Despite the omission, a court should impose a duty on the landlord to maintain the identifiability of a tenant's security deposit through application of the obligation of good faith.¹⁰⁴ Because the consequence of an inability to identify the collateral is asymmetrical—advantaging the landlord and disadvantaging the tenant—the concept of

102. Even if by original delivery the tenant transferred title to the money to the landlord, the landlord would be a secured party, the money (and any proceeds) would be collateral, and the provisions of Article 9 with regard to rights and obligations of the parties would apply. U.C.C. § 9-202 (2012 Official Text). This means that the landlord would be obligated at the end of the lease term to return collateral in excess of the amount owed by the tenant. Although Article 9 does not explicitly require a secured party to release collateral in its possession or under its control when the secured obligation has been satisfied, such an obligation clearly exists. *See id.* § 9-208 cmt. 4, which indicates that under the common law a failure to relinquish possession would constitute a conversion and then states that “[i]nasmuch as problems apparently have not surfaced in the absence of statutory duties under former Article 9 and the common-law duty appears to have been sufficient, this Article does not impose a statutory duty to relinquish possession.” The same rationale would apply to collateral under the secured party's control.

103. *See supra* note 7.

104. U.C.C. § 1-304 (2012 Official Text).

reasonable commercial standards of fair dealing¹⁰⁵ should be held to be applicable.

There are certain inherent risks that a tenant runs with respect to the deposited funds. For example, a landlord might dissipate the funds. It is highly unlikely that the tenant would be able to trace its funds to a third party, and even if it could do so it might not be entitled to their return.¹⁰⁶ A risk that is at least partially addressed by Article 9 is the exercise by the bank with which the account is maintained of a right of set-off or recoupment on account of an obligation of the landlord to the bank. Under Section 9-340(a), a bank that exercises such a right has priority over the secured party¹⁰⁷ and, as a type of transferee for value, would likely also take free of the tenant's ownership interest. Banks generally are not permitted to exercise set-off or recoupment against an account if they know that the funds in the account are held for a special purpose, such as to pay the wages of employees or as tenant security deposits. However, there is nothing in Article 9, other than the possible application of the duty of good faith, obligating a landlord to notify a bank of the source of the funds in an account maintained with the bank.

Now let's assume that the security deposit is paid by check. Although a check is an instrument for purposes of Article 9 when used as collateral,¹⁰⁸ an argument can be made that it does not function as collateral in this context. The landlord has a contractual right to enforce the check against the tenant, according to its terms, if it is dishonored by the tenant's bank.¹⁰⁹ Issuance¹¹⁰ of the check does not confer upon the landlord the right to any of the funds in the tenant's account. Section 3-408 makes this clear. It provides that "[a] check or other draft does not of itself operate as an assignment of funds in the hands of the drawee available for its payment, and the drawee is not liable on the instrument until the drawee accepts it." If the tenant's bank dishonors the check, the landlord's rights are against the tenant, not the bank. Nevertheless, the check undoubtedly constitutes property of the tenant before issuance and if anyone stole it, including the landlord, the tenant would have the right to get it back. Because the check is property of the

105. *Id.* § 1-201(b)(20).

106. There are numerous contexts in which security-deposit funds might be transferred. The degree to which a particular transferee takes free of a tenant interest in deposited funds, however, is beyond the scope of this article.

107. The exercise of set-off would be ineffective against the landlord if the bank's claim was against the tenant rather than the landlord. U.C.C. § 9-340(c) (2012 Official Text).

108. *Id.* § 9-102(a)(47) (instrument includes negotiable instrument); *id.* § 3-104(a), (c), (f) (defining check as negotiable instrument).

109. *Id.* § 3-414(b).

110. *See id.* § 3-105(a) ("Issue' means the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person"). *See also id.* § 1-201(b)(15) ("Delivery' . . . with respect to an instrument . . . means voluntary transfer of possession").

tenant, its issuance provides the landlord with a possessory security interest in it¹¹¹ and the funds the landlord receives when its bank collects the check are proceeds of that security interest. The analysis for checks is essentially the same as the analysis for money, an appropriate result given that checks commonly serve as a substitute for money.

Somewhat surprisingly, the analysis is quite different if a security deposit is paid by credit card. The charge slip signed¹¹² by the tenant authorizes the landlord to collect through the credit-card system, which is governed to a large extent by a series of contracts between the parties that operate within the system. After the tenant signs the slip, the landlord will send it to its bank, which is contractually obligated to make funds available to the landlord, typically at a discount. The landlord's bank will then forward the slip to a clearinghouse association, which will direct it to the card issuer. The issuer will settle with the landlord's bank pursuant to clearinghouse rules and then bill the tenant, who is contractually obligated to pay.¹¹³ Unlike a transaction involving money or a check, no property of the tenant is ever delivered to the landlord. Nevertheless, in our opinion the funds in the landlord's bank account should be treated as if they were the tenant's property based upon the tenant's expectations and contractual obligation to pay the issuer, as well as the close analogy to cash and check transactions in which security-deposit funds constitute property of the tenant.

If a credit-card transaction is a security transaction, the funds received by the landlord's bank are the original collateral, not proceeds.¹¹⁴ Like a deposit of cash or a check, the collateral is a "deposit account,"¹¹⁵ but in this context the landlord does not get the benefit of the continuing-perfection rule applicable to cash proceeds. Nevertheless, the landlord's security interest is perfected from the moment of attachment without the necessity of taking any action. Subject to the cash-proceeds rule described above, control is the exclusive method for perfecting a security interest in a deposit account,¹¹⁶ and under Section 9-104(a)(3) a secured party has control if it "be-

111. Like money, instruments are listed in Section 9-313(a) as a type of collateral capable of being possessed. Accordingly, an authenticated security agreement describing the collateral is not necessary for attachment to occur. *Id.* § 9-203(b)(3)(B).

112. A signature in this context might be either physical or electronic. *See, e.g., id.* § 1-108.

113. This brief description of the process is based on BARKLEY CLARK AND BARBARA CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS*, ¶ 15 (revised ed. 1998).

114. As is the case with collateral in a secured party's possession, an authenticated security agreement describing the collateral is not required if the collateral is in the secured party's control pursuant to Section 9-104. U.C.C. § 9-203(b)(3)(D) (2012 Official Text).

115. As noted above, it is our opinion that a part interest in a deposit account is itself a deposit account for purposes of Article 9. *See supra* note 100 and accompanying text.

116. U.C.C. §§ 9-310(a), (b)(8), 9-312(b)(1), 9-314(a), 9-104(a) (2012 Official Text).

comes the bank's customer with respect to the deposit account." Because the landlord is at all times the bank's customer with respect to the account, perfection of its security interest is in effect automatic.

Because the collateral is a deposit account, a question arises whether the security aspect of the lease transaction is excluded from the scope of Article 9. Section 9-109(d)(13) provides that the article does not apply to "an assignment of a deposit account in a consumer transaction, but Section 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds." In a cash or check transaction, the funds in the landlord's account constitute proceeds and thus the exclusion by its own terms does not apply. Does it apply when the funds are the original collateral? The transaction at issue qualifies as a consumer transaction, but in our opinion there has not been an assignment by the debtor in the sense contemplated by the statute and thus the exclusion does not apply.

In a consumer transaction, an individual incurs an obligation for personal, family, or household purposes¹¹⁷ and provides collateral to secure the obligation.¹¹⁸ Those requirements clearly are met in residential lease transactions. In addition, the collateral must be held for personal, family, or household purposes.¹¹⁹ This requirement is met as well, even though the landlord physically holds the collateral for a commercial purpose. A typical consumer transaction involves the use of consumer goods¹²⁰ as collateral for a consumer loan, and in most instances the collateral will be in the possession of the debtor pending default. Surely, however, the mere fact that a debtor might permit a secured party to take possession of consumer goods pending payment of a consumer obligation would not deprive the debtor of the protections afforded consumer transactions under Article 9.¹²¹ Similarly, the fact that a landlord is in control of a deposit account representing a tenant's security deposit should not preclude a transaction from qualifying as a consumer transaction.

In the typical transaction excluded from Article 9 by Section 9-109(d)(13), a consumer obligor attempts to assign to a secured party an interest in the obligor's personal deposit or savings account as collateral for a

117. Article 9 refers to such an individual as a "consumer obligor." *Id.* § 9-102(a)(25).

118. *Id.* § 9-102(a)(26)(i), (ii).

119. *Id.* § 9-102(a)(26)(iii).

120. If the collateral is consumer goods, the consumer transaction also constitutes a consumer-goods transaction. *Id.* § 9-102(a)(26), (24). A consumer transaction might also involve the use of investment property held by the debtor for a personal, family, or household purpose. *See id.* § 9-102(a)(26).

121. The same analysis would apply if a debtor gave a secured party control of, *e.g.*, a certificated security that represented a consumer investment as collateral for a consumer obligation. *See id.* § 9-106(a), 8-106(a), (b).

consumer obligation.¹²² That is not at all what happens when a landlord collects a security deposit through the credit-card system; rather, the relationship between the tenant and the funds in the landlord's account—the deposit account—is tenuous at best. Perhaps the most logical and straightforward conclusion would be that the funds belong to the landlord from the moment of collection. This alone would not prevent the application of Article 9—under Section 2-202 the article's provisions with regard to rights and obligations apply whether title to collateral is in the debtor or the secured party—but only by application of Article 9 would one conclude that the tenant has any rights in the funds in the first place. It is difficult to see the landlord's interest in the deposit account as flowing from an assignment by the tenant.

One way to avoid the conceptual difficulties inherent in a credit-card transaction would be to conclude that the transaction should create only a debtor/creditor relationship between the landlord (as debtor) and the tenant (as creditor) and that Article 9 should not be stretched to cover that relationship. The landlord's obligation would be to pay the tenant, at the end of the lease term, the amount by which the security deposit exceeds the tenant's obligations under the lease. Nevertheless, we prefer to apply Article 9 to a credit-card transaction because, in our view, there should not be a difference in treatment depending on the method by which a security deposit is paid. Of course, one might argue that the balance should be in the other direction; that is, that a cash or check transaction should create a debtor/creditor relationship and be outside the scope of Article 9. However, this would not provide a tenant with any protection in the event of a landlord's bankruptcy. The better policy is for Article 9 to apply broadly to security deposits because that approach provides greater protection for tenants.

IV. A MODEST PROPOSAL FOR THE REVISED UNIFORM RESIDENTIAL LANDLORD AND TENANT ACT

As noted above, the ULC is in the process of revising the URLTA. At the request of the Executive Director of the ULC, the authors were asked to serve with others in an ad hoc group¹²³ providing advice to the drafting committee with regard to certain issues relating to security deposits. This advice, more specifically, took the form of determining the most appropriate mechanism for maximizing the protection of both landlords and tenants

122. Article 9 does not invalidate the transaction; rather it simply excludes the transaction from its scope. Whether an assignee of a consumer's bank account in the context of a consumer loan may enforce rights in the account turns on other law. *See, e.g.*, U.C.C. § 9-109 cmt. 13 (2012 Official Text).

123. The other members of the ad hoc group were Neil B. Cohen, Jeffrey D. Forchelli Professor of Law, Brooklyn Law School, and Edwin E. Smith, Esq., a partner in the law firm of Bingham McCutcheon LLP.

against creditors of the other, particularly including trustees in bankruptcy. The group decided against an approach under which a landlord would hold security deposits in trust because such an approach would require the importation of broad law-of-trust principles into landlord-tenant law. Instead, the group suggested a narrower approach based upon, but resolving many of the problems associated with, Article 9.

Although we are of the opinion that Article 9 applies to security deposits, the issue is not free from doubt, especially, as noted above, in the case of a security deposit paid by credit card or similar mechanism. Further, while we are of the opinion that the exclusion from Article 9 for assignments of deposit accounts in consumer transactions¹²⁴ is not applicable to credit-card transactions, that too is not free from doubt. In order to ensure that a landlord's interest in a security deposit is treated as a security interest regardless of the source of the funds, the ad hoc group concluded that the revised URLTA should contain a provision to that effect. That said, there is no need to entirely exclude the application of Article 9, the provisions of which for the most part work perfectly well for security deposits. The following suggested provisions are based upon the work of the ad hoc group, but in some instances they go beyond the group's work to address concerns about the application of Article 9 that are raised in this article. The rationale for each provision, and in many instances the source of the language, is explained in the footnotes.

Definitions:

“Bank” means an organization that is engaged in the business of banking. The term includes savings banks, savings and loan associations, credit unions, and trust companies.¹²⁵

“Bank account” means a demand, time, savings, passbook, or similar account maintained with a bank.¹²⁶

“Lien creditor,” with respect to a security deposit, means:

- (A) a creditor that has acquired a lien on the security deposit by attachment, levy, or the like;
- (B) an assignee for benefit of creditors from the time of assignment;
- (C) a trustee in bankruptcy from the date of the filing of the petition; or
- (D) a receiver in equity from the time of appointment.¹²⁷

124. See U.C.C. § 9-109(d)(13) (2012 Official Text).

125. The definition is the same as *id.* § 9-102(a)(8) (defining “bank”).

126. The definition is adapted from *id.* § 9-102(a)(29) (defining “deposit account”).

127. The definition is adapted from *id.* § 9-102(a)(52) (defining “lien creditor”).

“Security deposit” means funds, in whatever form,¹²⁸ provided to a landlord by a tenant as security for the tenant’s obligation to pay accrued rent and any damages suffered by the landlord as a result of the tenant’s non-compliance with [Section 3.101].¹²⁹

“Security interest” has the meaning set forth in [Article 1 of the UCC].¹³⁰

Substantive Provisions:

(a) A landlord’s interest in a security deposit is a security interest and a tenant’s interest in a security deposit is an ownership interest.¹³¹

(b) A landlord must keep all its security deposits identifiable by i) holding the funds in a bank account that is used exclusively for security deposits, and ii) maintaining records that indicate at all times the amount of the funds attributable to each tenant’s security deposit.¹³²

(c) A landlord must, in a signed record,¹³³ notify the bank that maintains the bank account in which security deposits are held that the account is a special account for the purpose of holding tenant security deposits.¹³⁴

128. The reference to “funds” without regard to their form avoids all the categorization problems that arise under Article 9 and are described in the preceding section of this paper.

129. The language describing the tenant’s obligation comes from Section 2.101(b) of the original URLTA. UNIF. RESIDENTIAL LANDLORD AND TENANT ACT § 2.101(b) (1972) (amended 1974). Section 3.101 of that act sets out the duties of a tenant. *Id.* § 3.101. The tenant’s duties may be described elsewhere in the revised URLTA and the appropriate reference should be inserted in the brackets.

130. The definition of “security interest” is in U.C.C. § 1-201(b)(35) (2012 Official Text). The relevant part of the definition is the first sentence, which states that “[s]ecurity interest” means an interest in personal property . . . which secures payment or performance of an obligation.”

131. This straightforward declaration resolves all issues about the nature of the property interest of both landlord and tenant. The reference to the nature of the tenant’s interest goes beyond the work of the ad hoc group.

132. U.C.C. § 9-207(b)(3) (2012 Official Text) requires a secured party to maintain the identifiability of collateral in its possession but permits it to commingle fungible collateral. There is no parallel provision for collateral in the secured party’s control. The suggested provision would in all instances permit commingling while assuring the identifiability of each tenant’s funds. The drafting committee for the revised URLTA might consider whether to penalize a landlord that fails to comply with the provision.

133. It is assumed that the revised URLTA will contain the standard ULC definitions of “sign,” which includes both physical and electronic signatures, and “record,” which includes both physical and electronic documents.

134. The purpose of this provision is to protect security deposits from a bank’s right of recoupment or set-off. If the drafting committee concludes that this is not adequate, it might make subsection (e) subject to a new subsection, which might read as follows: “A tenant’s right to the return of some or all of a security deposit held in a bank account has priority over any right of set-off the bank with which the account is maintained may have for obligations owed to the bank by the landlord other than charges normally associated with the bank’s maintenance of the account.”

(d) If funds attributable to a tenant's security deposit are not identifiable based on the records maintained by the landlord and the tenant is entitled to the return¹³⁵ of some or all of the security deposit, identification of the funds attributable to the tenant may be accomplished by a method of tracing, including application of equitable principles, that is permitted under law other than this [act] with respect to commingled funds.¹³⁶

(e) All issues related to a landlord's security interest in a security deposit, including attachment, perfection, the effect of perfection and nonperfection, the priority of the security interest with respect to the rights of a purchaser or creditor, including a lien creditor,¹³⁷ and the rights and duties of the landlord¹³⁸ in enforcing its security interest, are governed by the provisions of [Article 9 of the UCC]¹³⁹ other than [Section 9-109(d)(13)].¹⁴⁰

(f) For purposes of the application of [Article 9 of the UCC], a landlord's security interest in funds in a bank account, without regard to whether the funds constitute proceeds, is a security interest in a deposit account as defined in [Section 9-102(a)(29)].¹⁴¹

135. Use of "return" rather than a word such as "reimbursement" stresses that a tenant's interest in a security deposit is a property interest.

136. This provision is based on U.C.C. § 9-315(b)(2) (2012 Official Text). The UCC provision is designed to aid a secured party in the event the debtor commingles property other than goods but, as indicated *supra* in the text accompanying notes 106–107, a similar provision in a residential lease context should protect only the tenant.

137. The priority rule as against a lien creditor is redundant given the cross-reference to Article 9 but is included for emphasis because of the importance of providing protection for the landlord in the event of the tenant's bankruptcy. The tenant's ownership interest provides protection in the event of the landlord's bankruptcy.

138. The ad hoc group took no position on the issue that was central to the cases discussed in Part II—whether to override U.C.C. § 9-207(c)(2) (2012 Official Text), which obligates a landlord that earns interest on a security deposit to account to the tenant for the interest. This policy decision is best left to the drafters of the revised URLTA.

139. The broad cross-reference to Article 9 will resolve any number of issues that might arise in the context of security deposits.

140. U.C.C. § 9-109(d)(13) (2012 Official Text) excludes from the scope of Article 9 an assignment of a deposit account (other than an interest in proceeds) in a consumer transaction. In our opinion, this provision does not apply to exclude the application of Article 9 in cases in which the initial collateral constitutes a deposit account (*see supra* text accompanying notes 119–23 and the paragraph preceding the paragraph containing note 119), but excluding application of the section will negate any argument that the provisions of Article 9 do not apply. This provision goes beyond the work of the ad hoc group.

141. As discussed in *supra* notes 100 and 117 and in the text accompanying those notes, it is our opinion that under Article 9 a part interest in a deposit account is itself a deposit account. However, Article 9 does not expressly so provide and clarifying the issue is important for credit-card and similar transactions where the initial collateral consists of funds in the landlord's bank account. The landlord is in control of the collateral at all times and is thus perfected under U.C.C. § 9-104(a)(3) (2012 Official Text), and because the landlord is in control an authenticated security agreement describing the collateral (which is unlikely in this

(g) In the event of a conflict between this [act] and [Article 9 of the UCC], this [act] controls.¹⁴²

V. CONCLUSION

As noted above, it is our opinion that Article 9 should be applied to all lessee security deposits, whether the lease is of realty or of personalty. That said, Article 9 was not drafted with security deposits in mind and leaves too many questions unanswered. In particular, complex issues related to the characterization of the collateral and the exclusion for assignments of deposit accounts in consumer transactions arise when a security deposit is paid by credit card or a similar mechanism. It would be understandable, although regrettable, if some courts seized on the distinction between cash and check transactions on the one hand and credit-card and similar transactions on the other hand and concluded that Article 9 applies to the former but not the latter. Unfortunately, most courts have used outmoded reasoning to conclude that Article 9 does not apply to any security-deposit transaction. These courts, ignoring the plain language of the article and its substance-over-form approach, have incorporated into Article 9 a pre-Code distinction between a pledge and a debt and, based on that distinction, have concluded that a security deposit results only in a debt running from the lessor to the lessee. This approach is not only at odds with Article 9 itself, it is also at odds with the language used by the parties to express their intent—*security deposit*—and with their reasonable expectations.

The revision of the URLTA presents an opportunity for a fresh start. By clearly articulating that, without regard to the source of the funds that constitute the security deposit, the interest of a landlord is a security interest and that of a tenant is an ownership interest, the revised URLTA can legislatively overrule the approach based on the pledge/debt analysis. As we suggest above, the revised URLTA might also contain provisions that resolve certain other problems not clearly resolved by Article 9. For example, Article 9 requires a secured party to keep collateral in its possession identifiable but does not explicitly impose the same requirement if the collateral is in the secured party's control. The revised URLTA could make it clear that commingling is permitted but that identifiability must be maintained in all circumstances. The revised URLTA could then default to Article 9 for most other issues but make clear that credit-card and similar transactions are to be treated as being within the scope of the article and also make clear the appropriate characterization of the collateral in those transactions.

context) is not required for purposes of attachment. *Id.* § 9-203(b)(3)(D). This provision goes beyond the work of the ad hoc group.

142. This is necessary for the dual application of the revised URLTA and Article 9 to function properly.

In the ideal world, both Article 9 and the URLTA could be revised contemporaneously to resolve the problems associated with the treatment of residential lease security deposits. In the real world, contemporaneous revision of both statutes is impractical. Without amendments to Article 9, courts will continue to face the relevance of the pledge/debt dichotomy to leases of commercial realty and of personalty. In that regard, hopefully the analysis of those cases that have gotten the issue right—and the analysis set forth in this article—will ultimately win the day.