

COHEN, SALK & HUVARD, P.C.
ATTORNEYS AT LAW

BENNETT L. COHEN
BRUCE ALAN SALK
BRUCE K. HUVARD
BARRY I. MORTGE
CHRISTYL L. MARSH
NICOLE S. LALICH

630 DUNDEE ROAD, SUITE 120
NORTHBROOK, ILLINOIS 60062

TEL 847.480.7800
FAX 847.480.7882
E-MAIL BCOHEN@CSHLEGAL.COM

WRITER'S DIRECT DIAL 847.480.7989

December 4, 2006

SECURED LENDING ALERT

EXAMINING SECURITY INTERESTS IN DEPOSIT ACCOUNTS

This article examines the rules for perfecting a security interest in deposit accounts under Revised Article 9 of the Uniform Commercial Code (the "Revised Code").

Security interests in deposit accounts were outside the scope of former Article 9 of the Uniform Commercial Code, except for proceeds from the sale of collateral. However, under the Revised Code, a security interest can be taken in deposit accounts as original collateral, except in consumer transactions. Official Comment 16 to Code Section 9-109 provides that "[e]xcept in consumer transactions, deposit accounts may be taken as original collateral under this Article."

This article describes the perfection of a security interest in a deposit account in a commercial transaction. Under Code Section 9-109(d)(13), a security interest in a deposit account in a consumer transaction is outside the scope of the Revised Code and would be governed by common law (except with respect to deposit accounts as proceeds under Code Section 9-315, and with respect to priorities in proceeds under Code Section 9-322).

Discussion:

A. A "deposit account" is defined in Code Section 9-102(29) to be a "demand, time, savings, passbook, or similar account maintained with a bank. The term does not include investment property or accounts evidenced by an instrument."

B. Under the Revised Code, the only way to perfect a security interest in a deposit account claimed as original collateral, in a commercial transaction, is by taking "control" of the deposit account.

Under Code Section 9-104, there are three (3) ways that a secured party can obtain control of a deposit account in a commercial transaction:

Control Methods:

(1) under Code Section 9-104(a)(1), a secured party automatically has control over a deposit account if the secured party is the bank itself where the deposit account is maintained;

(2) under Code Section 9-104(a)(2), if the deposit account is maintained by a bank who is not the secured party, a secured party achieves control by having the debtor, secured party and the depository bank agree in an authenticated record (i.e., a written control agreement) that the depository bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; and

(3) under Code Section 9-104(a)(3), if the deposit account is maintained by a bank who is not the secured party, a secured party achieves control by becoming the bank's customer with respect to the deposit account. This third control method may be problematic. It's unclear what it means under this Code Section for a secured party to "become the bank's customer with respect to the deposit account". Code Section 4-104(a)(5) defines "customer" as a person have an account with a bank... In light of the fact that (i) a secured party employing this method typically does not fully register the deposit account in its name (including using its federal employer's identification number for the account, which would have tax consequences for the secured party), and (ii) the Official Comment to Code Section 9-104 is silent on the mechanics of establishing this specific control method, secured parties need to be careful relying on this control method. It would appear that a more conservative approach to employing this specific control method would be to require, in addition to titling the account in the secured party's name, that a security agreement be signed in favor of the secured party by both the debtor and the secured party itself (in its capacity as the titleholder). Albeit clumsy, the secured party would sign the agreement in two different capacities, as customer on the account and again as secured party.

In addition to obtaining control of the deposit account under Control Methods number 1 or 2 above, the secured party must have a security agreement signed by the owner of the deposit account granting to the secured party a security interest in the deposit account (except that if the secured party is the depository bank under Control Method number 1 above, a simple grant of security interest in the deposit account set forth in an account agreement or other writing signed by the owner should be sufficient).

Code Section 9-104 provides the following helpful guidance for crafting control agreements for deposit accounts: (i) under Section 9-104(b), a secured party which has

achieved control of a deposit account by one of the methods described in the paragraph will still have control of such account despite the fact that the debtor retains the right to access the account, and (ii) Official Comment 3 to Section 9-104 provides: "[a]n agreement to comply with the secured party's instructions suffices for "control" of a deposit account under this section even if the bank's agreement is subject to specified conditions, e.g., that the secured party's instructions are accompanied by a certification that the debtor is in default."

Obviously, features such as permitting the debtor access to the account and/or requiring a debtor default for the secured party's exercise of control over the account would typically not be used in a control agreement for a blocked deposit account of the type used in accounts receivable and/or inventory financing transactions.

If a secured party uses the three-party control agreement as its method of obtaining "control" of the deposit account, it is important that the document be carefully drafted to fully protect the secured party's interest in the pledged deposit account. Such agreement should include the depository bank's agreement to waive any right to setoff or to claim any deductions or security interest or banker's lien with respect to the deposit account. An exception is sometimes negotiated granting the depository bank the right to setoff the face amount of any checks returned unpaid because of uncollected funds, and for customary fees and expenses for maintaining the account.

C. Under Code Section 9-342, a depository bank is not obligated to enter into a control agreement even if its customer so requests or directs. If a secured party encounters a depository bank who refuses to sign a control agreement at all or one in form acceptable to the secured party, the deposit account needs to be moved to another bank that will be cooperative with the secured party.

D. Official Comment 3 to Section 9-104 cautions: "[p]erfection by control is not available for bank accounts evidenced by an instrument (e.g., certain certificates of deposit), which by definition are 'instruments' and not 'deposit accounts.' See § 9-102 (defining 'deposit account' and 'instrument')." Many certificates of deposit today are properly classified as "deposit accounts" and perfected by control as provided above.

If a certificate of deposit is described on its face as negotiable or transferable, it would be classified as an "instrument" under the Revised Code and the secured party would need to take possession of the original certificate of deposit for perfection purposes (and obtain any necessary indorsement or assignment thereof from the owner). Thus, secured parties taking a certificate of deposit account as collateral need to obtain and review a copy of the certificate to make sure it is non-transferable, or otherwise confirm that no negotiable or transferable certificate has been issued for such account.

E. Under Code Section 9-327(1), a secured party having control of a deposit account under Code Section 9-104 has priority over a conflicting security interest held by a secured party that does not have control of such account.

F. Under Code Section 9-327(2), subject to the exceptions described below, multiple security interests in the same deposit account each perfected by control under Code Section 9-104 rank according to priority in time of obtaining control (first in time to

perfect by control wins). However, Code Section 9-327(3) provides a significant exception to this general rule and provides that a depository bank holding a security interest in a deposit account at its own institution has priority over a conflicting security interest held by another secured party (even one that has been perfected by control) unless: (i) the secured party has obtained control under Code Section 9-104(a)(3) described above (having become the bank's customer for the deposit account), or (ii) unless the depository bank has either subordinated or disclaimed any security interest in the deposit account in the control agreement executed by it in favor of the secured party.

It is recommended that each control agreement obtained by a secured party for a deposit account include the following provisions: (i) the depository bank should confirm that no other party has lodged a control agreement with the depository bank for the deposit account, (ii) the depository bank should agree not to execute or accept any other control agreement for the deposit account, and (iii) the depository bank should either subordinate or waive any security interest, bank lien or other encumbrance it may now or hereafter claim in the deposit account or the funds in such account.

G. If a secured party does not obtain control of the deposit account because it has failed to satisfy one of the three methods for control set forth in Section B above, it may still attempt to claim a derivative security interest in the deposit account or a portion thereof if it can successfully trace identifiable proceeds from the sale of the secured party's collateral (such as inventory or equipment) or the collection of accounts receivable under Code Section 9-315. Official Comment 3 to this Code Section strongly validates common-law tracing methods such as the lowest intermediate balance rule.

However, a secured party who claims a derivative security interest in a deposit account in reliance on tracing of proceeds is exposed to much greater risks than a secured party who has perfected its security interest in a deposit account by control, for a multitude of reasons, including:

(1) The secured party may not be able to successfully trace proceeds of its collateral into the deposit account and would thus be unable to make a claim to such proceeds. In other words, the secured party's security interest in the funds in the account would be unperfected and wiped out in a bankruptcy, as well as primed by other lien creditors.

(2) As indicated above, a derivative security interest in the deposit account would be subordinate to a security interest in such account perfected by control under Code Section 9-104.

(3) Under Code Section 9-341(3) and Official Comment 3 thereto, the depository bank ordinarily owes no obligation to obey the secured party's instructions (in the absence of such depository bank's written agreement to do so), and such depository bank can continue to follow the debtor's (customer's) instructions by honoring checks and permitting withdrawals with respect to the funds deposited in the account "until such time as the depository institution is served with judicial process..."

(4) Code Section 9-332(b) provides that "[a] transferee of funds from a deposit account (for example, a payee of a check issued on such account) takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party."

The Official Comment to this Code Section explains the policy behind this statute: "[b]road protection for transferees helps to ensure that security interests in deposit accounts do not impair the free flow of funds. It also minimizes the likelihood that a secured party will enjoy a claim to whatever the transferee purchases with the funds. Rules concerning recovery of payments traditionally have placed a high value on finality. The opportunity to upset a completed transaction, or even to place a completed transaction in jeopardy by bringing suit against the transferee of funds, should be severely limited.

The only exception listed in Code Section 9-332(b) is when the transferee of the funds acts in collusion with the debtor to violate the rights of the secured party.

(5) The risk of an innocent transferee taking funds free of a secured party's security interest cited in subsection (4) above would apply to both (i) a deposit account in which the secured party claims a security interest in proceeds of its collateral deposited in the account, and (ii) a deposit account in which a secured party obtains control of the deposit account using a written control agreement, unless the secured party, uses a control agreement which blocks all withdrawals by the account owner.

Some deposit account control agreements provide that the account owner can utilize the account until some event of default occurs under the secured obligation and notice by the secured party to take exclusive control of the account is served on the depository bank (at which time no further withdrawals by the account owner is typically permitted). The risk that innocent transferees of funds from the deposit account can take free of the secured party's security interest remains until the secured party has taken control of the account and blocked all further withdrawals by the account owner.

This article is informational in nature and is not intended to constitute, nor should it be relied upon as, legal advice to any recipient.

Bennett L. Cohen, Esq.
Cohen, Salk & Huvard, P.C.