SECURITY INTERESTS IN DEPOSIT ACCOUNTS

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INTRODUCTION.

Among the July 2001 revisions to Article 9 of the Uniform Commercial Code ("UCC") was the expansion of the collateral covered to include deposit accounts. Because deposit accounts were not previously covered by Article 9, secured lenders rarely attempted to take a security interest in them except in special situations. However, with the greater certainty afforded by revised Article 9, deposit accounts have become an important source of collateral that lenders should consider. This article will review the mechanics of perfecting a security interest in deposit accounts and discuss related considerations secured lenders should be aware of in this process.

DEFINED TERMS.

Revised Article 9 defines a deposit account as a "demand, time, savings, passbook or similar account maintained with a bank." The term does not include investment property, such as stocks, bonds, or accounts evidenced by an instrument, such as certificated certificates of deposits ("CDs"). Uncertificated CDs, however, are covered. The term "bank" as used in the Article 9 definition includes any depository institution. As used in this article, "bank" means the depository institution, as distinguished from the lender. Under revised Article 9, there are limits to use of deposit accounts as collateral. A lender cannot take a security interest in a deposit account in a consumer transaction; conversely however, a lender may take a security interest in a consumer's deposit account in a business transaction.

To perfect its lien in the debtor's deposit account, the lender must gain "control" over the debtor's deposit account. Revised Article 9 lists three methods, any of which, if satisfied, give the lender the requisite control over the debtor's deposit account. If the lender is also the financial institution at which the deposit account is maintained, i.e., the "bank", then the lender has automatic perfection in and control over the deposit account, and no separate agreement is needed. Alternatively, if the deposit account is maintained at a different bank in the name of the lender on behalf of the debtor, the lender will also have control over the deposit account, and no separate agreement is needed. The foregoing method of perfection is usually objectionable to the debtor because once the deposit account is placed in the lender's name, the debtor loses access to the funds in that deposit account. The third, and most common, way for the lender to perfect its security interest in and gain control over the debtor's deposit account is for the debtor, the lender and the bank to agree in an authenticated record that the bank will comply with instructions originated by the lender directing disposition of the funds in the deposit account without further consent by the debtor. The "authenticated record" to which Revised Article 9 refers typically takes the form of an agreement among the debtor, the lender and the bank (a "Control Agreement"). Each of the three methods outlined above is an effective means by which a lender may perfect its security interest in and gain control over the deposit account; the filing of a UCC-1 financing statement is not effective to perfect a security interest in a deposit account *nor* is a mere notice from the lender to the depositary bank sufficient.

PRIORITIES.

Even if a lender has control over the account by using one of the above methods, the debtor may retain the right to direct disposition of the account funds without affecting the lender's control, since revised Article 9 expressly authorizes the debtor to direct disposition of funds without defeating control by the lender. Once a notice is received by the bank, often called a "notice of exclusive control", the debtor's ability to direct disposition will be terminated. A Control Agreement usually does not outline the conditions that must be satisfied to enable the lender to send the bank a notice of exclusive control. Instead, the loan documents between the debtor and the lender should specify that the lender is entitled to send a notice of exclusive control to the bank when an event of default has occurred and is continuing under the loan documents. Sending the notice of exclusive control to the bank and having the right to exercise exclusive control over the funds in the deposit account is one of the remedies of which a lender may avail itself when the debtor is in default under the loan documents. The method of gaining control is crucial because not all methods of control are equal when it comes to determining the priority of security interests in a deposit account and entitlement to the funds deposited in same.

CONTROL AGREEMENTS.

A lender that gains control over a deposit account by holding title to the account and thereby becoming the bank's customer will have priority over other secured lenders and most setoff rights of the depository bank. Although the bank's rights will usually be superior to a lender perfected only through a Control Agreement, the Control Agreement should, from the lender's point of view, subordinate the bank's setoff rights to the rights of the lender or at least limit the bank's rights to fees and costs related to the account, such as recoupment of funds for provisionally settled items that are subsequently reversed. Note that lenders who only have an interest in funds in an account as proceeds of other collateral will lose out to lenders who have perfected through control. Thus, it will be crucial for lenders relying on a perfected interest in receivables to gain control of their borrowers' deposit accounts or risk losing those proceeds to a lender that has perfected a security interest in the deposit accounts through control.

Unless control is established, any pledge of such a deposit account is unperfected even if the bank knows of such pledge, and even if the bank receives instructions from the party which is secured, but unperfected. The bank need not obey, and indeed probably has liability for obeying, such instructions. Therefore, a party with an unperfected security interest in a deposit account, including a party having an interest only in proceeds of other collateral such as inventory, will need a judicial order to reach proceeds, much as a secured party today needs to obtain a garnishment or attachment order.

Depository institutions need to decide if they will enter into Control Agreements; revised Article 9 specifically states that banks are not required to enter into such agreements. Nevertheless, banks may not have a choice if market pressure favors banks that will accept Control Agreements. A bank will need to decide if it wants to use its own form of Control Agreement or if it will accept forms from other lenders. The bank will need to determine which

department or personnel will be in charge of accepting, negotiating, implementing and monitoring Control Agreements, and how the bank will receive and process secured parties' instructions with respect to deposit accounts subject to Control Agreements.

Secured lenders should require disclosure of debtor's deposit accounts in their form security agreement questionnaire, and lenders should take a security interest in deposit accounts as part of any blanket lien. If a lockbox account is already in place, lenders may want to be sure that title to such account is in the lender's name or that the lockbox or collateral account agreement meets the requirements for a Control Agreement under the revised Article 9 of the UCC. Lenders should consider developing their own form of Control Agreement. Lenders that are also the depository institution will need to decide whether they will rely on their rights as a "bank" under revised Article 9, obtain title to the account to ensure their priority, or enter into a Control Agreement.

CONCLUSION.

In a secured transaction under revised Article 9, the lender may take a security interest in its debtor's deposit accounts but must perfect that security interest by obtaining "control" over it. A Control Agreement perfects the lender's security interest and establishes and sets forth a debtor's and the lender's rights to and control over the funds maintained in a deposit account that is pledged as collateral by a debtor to a lender. Such agreement will also typically set forth the depository bank's reimbursement rights for returned items. While the Control Agreement is in effect, the lender will have a perfected security interest in the pledged deposit account. Under the terms of most Control Agreements, the debtor will be authorized to access the funds in the account so long as the lender has not sent a notice of exclusive control to the bank. Upon the occurrence of a default under the loan documents between the debtor and the lender or other negotiated event, the lender may send such a notice to the bank. Once the bank receives the notice of exclusive control, the lender will have exclusive control over the funds in the deposit account unless and until the lender relinquishes control over the deposit account.

Because the law in this area was only changed in July, 2001, there are many unresolved issues that could result in litigation. The ability of judgment creditors to garnish accounts may be severely hampered. There are new potential areas for lender liability, and banks may face litigation for obeying, or not obeying, a secured lender's instructions in a timely fashion. Lenders should revise their security agreement questionnaires to capture their debtor's deposit information. The form and content of the Control Agreements also presents potential "battle of the forms" issues between banks as depository institutions and secured lenders.

This article is not intended to provide legal advice for a specific transaction. If you require further information on any matter contained in this article or would like to discuss a specific transaction, please feel free to contact either Mr. Goetz or Mr. Hoffmann at (516) 296-7000.