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Deposit and Security Account Control Agreements Under the UCC

Perfecting Security Interests in Special Collateral Types

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Perfecting Security Interests in Deposit Accounts

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What is a Deposit Account?

- This term is broadly defined to include a demand, time, passbook, or similar account maintained by a bank (9-102(a)(29)).
- Banks sometimes prefer to create securities accounts for control purposes rather than deposit accounts. A securities account can hold funds as well as securities, whereas a deposit account can only hold funds.
- An “instrument” is not a deposit account. There are fewer and fewer of these around now.

Some Basic Rules

- A secured party can only take a security interest in a deposit account in a commercial transaction (as opposed to a consumer transaction.)(9-109(d)(13)).
- In some instances where Article 9 does not apply to a transaction, other law fills the gap – but not here.

Basic Rules

- For most types of collateral, filing is an option, even if it is not the most effective means of perfection. This is not true of deposit accounts.
- For deposit accounts, the secured party may only perfect by “control” (9-312(b)(1)).

How Does the SP Perfect by Control?

- Under 9-104, there are several options:
- A SP may be the bank with which the deposit account is maintained.
 - Even in this situation, a depository bank acting as Agent or Custodian in a transaction may require a control agreement with itself in its capacity as depository bank.

Perfection by Control

- Second method: the SP becomes the bank's "customer." The meaning of "customer" is defined in 4-104(a)(5) ("a person having an account with a bank)."
- In a secured transaction, it may not be clear who the "customer" is if both names (D and SP) appear on the account title and if the D has the right to direct the bank.
- This is a less secure method of obtaining control than having a control account.

Control Agreements

- The most reliable method of establishing control is for the bank, D and SP to enter into a “control agreement” (“DACA” for “Deposit Account Control Agreement”). This is the method referred to in 9-104(a)(2):
- The D, SP, and bank have agreed ...that the bank will comply with instructions originated by the SP without further consent by the D.”

Transferee of Funds from a Deposit Account

- Even when a control agreement exists, it is customary for it to provide that the D will have all incidents of ownership of the account (including the right to write checks and transfer funds) until the SP notifies the bank to terminate D's access.
- If the D transfers funds out of the account, they are no longer subject to the security interest (9-332).

Transferee of Funds from a Deposit Account

- The one exception is when the transferee has acted “in collusion with the D in violating the rights of the SP” (9-332(a)).
- This rule is intended to preserve the rules that normally apply to the payment system – payments from banks are final; the recipient need not be concerned about prior security interests.

Transferee of Funds from a Deposit Account

- This is a major risk for the SP, as it is not uncommon, when the D anticipates that the SP may soon contact the bank to cut off its access to the account, to spend it down.
- Many banks require a short period, such as two days, between the time the notice is received and the D's access terminates.

Bank's Rights

- Nothing requires a bank to agree to enter into a control agreement, even if the customer (D) requests it to do so. As may practitioners can testify, when control agreements were less commonly used than today, many banks arbitrarily refused.

Bank's Rights

- A bank need not confirm the existence of a control agreement unless requested to do so by its customer (9-342).
- This does not address the opposite situation – if the account is not brand new, the bank may be asked to confirm the lack of any other control agreement governing the account. The bank's response, if inaccurate, and if it leads to loss by the SP, would be governed by tort law, not Article 9.

Bank's Rights

- The bank's rights and duties with respect to its customer (as established by other law and the bank's agreements) cannot be modified by implication as the result of a control agreement or the SP's security interest (9-341). Therefore, the SP's control agreement does not terminate any security interest the depository bank already has.

Bank's Rights – recoupment and setoff

- Recoupment is not defined in Article 9. It is, loosely, the recovery of funds arising out of the same transaction. Thus, if a bank gives a customer credit for a check before it has cleared, and it fails to clear, recovery of the funds can be had in recoupment.
- Setoff is the extinguishment of mutual debts that are both matured.
- These are common law rights.

Bank's Rights

- In general, the existence of a perfected security interest in a deposit account does not limit these bank rights. However: -
- If the secured party has perfected by becoming the bank's customer, the bank may not exercise its right of setoff if the claim is based on a debt of the D. The bank may still exercise its right of recoupment (9-340).

Security Interest vs. Setoff

- Note that a bank may have a security interest in its customer's account as well as a common law right of setoff (9-340, comment 3).
- Where do you find this security interest? Look at the loan agreement between the bank and its customer. There will generally be boilerplate.
- Bank may generally exercise these rights independently.

Priorities (9-327)

- Control beats any other type of perfection. Since filing is not an option, the type of perfection it beats is continued perfection in proceeds where a security interest in the underlying collateral was previously perfected (9-315).

Priorities

- If there are two security interests perfected by control, the earlier one wins.
- This situation should not occur. The bank should be able to tell a prospective SP that there is no other security interest perfected by control.

Priorities

- A security interest held by the depository bank always has priority
 - EXCEPT: if the SP has perfected by becoming the bank's customer, that SP has priority over the depository bank.

Priority in Proceeds

- These priorities are governed by 9-322(c)-(e). They may permit the SP to recover the proceeds of the deposit account if, for example, funds are spend to obtain non-cash items.

Concerns of the Debtor

- These are generally accounts that the D needs in order to perform transaction requirements (make collections and disbursements) or, more broadly, for general operating purposes.
- It is in the debtor's interest to negotiate provisions that prevent the SP from terminating D's access to the account except for a material financial default.
- Indemnities are generally unpalatable, but are difficult to eliminate.

Concerns of the SP

- SP may be required to indemnify the bank. It may be difficult/impossible to eliminate or modify these indemnities.
- How long does it take for the bank to act once the SP notifies the bank that it is terminating the D's access to the account? The bank will generally wish several days to determine if there are conflicting claims to the funds (including its own). These last days and hours are crucial to the SP, since the D may drain the account once it suspects the SP is about to act.

Concerns of the SP

- What information is provided to the SP on an ongoing basis? The delayed snapshot provided by account statements may be insufficient.
- Bank should make reps and warranties as to the nonexistence of other security interests.
- Bank should subordinate its security interest and setoff rights to those of SP.
 - Bank may not be willing to subordinate recoupment rights – but these may not be significant.

SP's Concerns

- Bank will usually not be willing to subordinate its fees and expenses.
- The deposit agreement must stay in place as long as the account exists – should not be possible for bank and D to terminate it.
- But if control agreement is terminated, SP should receive the funds.
- The control agreement should extend to the account as it may be renumbered/renamed.

Bank's Concerns

- Indemnity from both SP and D
- Establishing a standard of care
- Limitation of liability
- Completion of tax forms and KYC requirements
- Reliance on signatures; instructions
- Compensation
- Termination rights
- (Frequently): institution-specific bank boilerplate

Core Requirements of the Control Agreement

- Agreement must be “authenticated” – 9-102 term meaning executed manually or electronically.
- Agreement must contain “magic language”:
 - Bank will comply with instructions of SP concerning disposition of funds w/o further consent of D
 - However, most banks and SPs want more detail.

Form of Entitlement Notice

- A DACA will provide for a form of Entitlement Notice, which is the document that, when executed, tells the bank to attorn to the SP.

The form of the notice is provided so that, when the day comes, the SP will not run the risk of having the bank reject its form.

The ABA's Model DACA

- The ABA's Business Law Section has created a model DACA. It is publicly available by going to the Business Law Section tab of the ABA web site. If you Google "deposit account control agreement" you will find commentaries incorporating this agreement. Also see: 61 Business Lawyer, Feb. 2006.

Model DACA

- Structure:
 - 1) Generally applicable terms and conditions
 - 2) Brief agreement containing blanks for the insertion of
 - Transaction specific provisions
 - Anything that modifies the general terms and conditions

Model DACA

- There are also a number of inserts that can be used for specific situations:
 - Lock box arrangements
 - Non demand deposit accounts
 - Sweeps
 - Second liens
 - Securitizations

Model DACA

- Advantages:
 - Balances the requirements of the SP and bank
 - Comprehensive
 - Clearly written (ambiguities may result from negotiated provisions appearing in a standard bank-drafted agreement)

In-house Forms

Source: RealDealDocs.com

Advantages:

- ABA form requires learning curve for bank counsel
- In-house form can be executed by nonlegal bank officer w/o need for review by counsel
- In-house forms are simpler, cover the basics

Analysis of Standard In-house DACA

1. Identification of account (add “and any other accounts at the bank that replace this Account”)
2. Preamble (expand statement of background of transaction)
3. “Magic language”
4. No prior security interests (recall that the SP can’t discover these by searching the filing system). Should also be warranty.

Analysis of Standard In-house DACA

4. D's right to use funds in the account prior to "activation period" – notice day plus 2 days. The two day gap permits the bank time to process SP request and check for legal process or other reason it should not act.
5. Account can't be closed while agreement is in effect.

Analysis of Standard In-house DACA

6. Waiver of bank's right of setoff except for
 - its fees
 - recoupment for prior credit if a check that was deposited was not paid
7. Information to be provided to SP
8. Limitation of liability and exculpation (negotiable)
9. Indemnification (here, gross negligence and intentional misconduct – negotiable)

Analysis of Standard In-house DACA

10. Termination (important to limit or provide for adequate notice so SP can replace bank)
11. Reps of each party
12. Amendments in writing
13. Counterparts
14. Disclaimer as to status of parties

Additional Provisions

- Provision for overnight investment of funds (may replace DACA with Securities Account Control Agreement if investment of funds is important to parties)
- Which party reports earnings to IRS
- Duty to complete IRS forms and provide KYC info.
- Compensation of bank
- Providing SP with notice of adverse claims
- *Force majeure* provisions

Additional Provisions

- Communications; verifying instructions given by SP

Perfecting Security Interests in Deposit Accounts, Securities Accounts and Other Investment Property

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INVESTMENT PROPERTY

- Definition 9-102(a)(49)
 - Security
 - Uncertificated
 - Certificated
 - Security Entitlement
 - Securities Account
 - Commodity Contract or Account

OTHER DEFINITIONS

- Security 8-102(a)(15)
 - Type traded on securities exchanges or markets
 - Governed by Article 8
- Certificated Security 8-102(a)(4) – security represented by certificate
- Uncertificated Security 8-102(a)(18)

OTHER DEFINITIONS

- Securities Entitlement – 8-103(a)(17)
the interest of an entitlement holder to a financial asset
- Financial Asset
 - Security
 - Interest dealt with on financial markets
 - Property held by securities intermediary in a securities account

OTHER DEFINITIONS

- Securities Intermediary 9-102(a)(14)
 - person who maintains security accounts for others in the ordinary course.
- Securities Account 8-501(a)
 - an account in which a financial asset is credited in which the account holder can exercise rights to the financial asset

OTHER DEFINITIONS

- Entitlement Holder – 8-102(a)(7)
 - A person having a security entitlement against the securities intermediary
- Security Entitlement – 8-102(a)(17)
 - the rights an interest of a entitlement holder
- Entitlement Order – 8-102(a)(8)
 - Order directing transfer of a financial asset

PERFECTION OF SECURITY INTERESTS

- Filing 9-312(a)
- Control 8-106
 - Certificated Securities
 - Bearer – delivered to purchaser
 - Purchaser includes Secured Party
 - Endorsed to purchaser or in blank
 - Registered in name of purchaser

PERFECTION BY CONTROL

- Uncertificated Securities
 - Purchaser becomes registered owner on books of issuer
 - Issuer agrees to comply with instructions by purchaser without further consent of registered owner

PERFECTION BY CONTROL

- Security Entitlement
 - Purchaser becomes entitlement holder
 - Securities intermediary agrees to comply with the entitlement orders of purchaser without further consent of the entitlement holder
 - Assigned control
 - Does not matter if debtor maintains certain rights as to the account

SECURITY AGREEMENT

- Regardless of the method of perfection, the debtor must grant a security interest as to third parties
 - Usually will not be in a control agreement with the issuer or securities intermediary

CERTIFICATED SECURITIES

- Due Diligence for certificated securities and uncertificated securities where control is obtained by notation
 - Check laws in state of formation and read Organic Documents for preemptive rights and rights of first refusal
 - Obtain Waivers

CERTIFICATED SECURITIES

- Drafting Tips for Security Agreement
 - Non-dilution provisions (may want issuer to join in)
 - Voting Provisions and Distributions
 - Proceeds

LLC Interests

- Not “securities” unless traded on exchanges
- Are general intangibles that can be perfected only by filing.
- Opt – In
 - Interest may provide it is a “security” governed by Article 8 (8-103(c))

OPT-IN

- Why Opt-In
 - Purchaser can obtain protected purchaser Status (8-303)
 - Take free and clear of adverse claims
 - If transfer is for value
 - No notice of adverse claim (8-105)
 - » Filed financing statement not notice
 - Obtains control

CONTROL AGREEMENTS

- Mainly for Securities Accounts
- Issues similar to DACAs
 - Need grant of security interest
 - Initial Block v. Debtor access
 - Indemnities

CONCERNS OF THE PARTIES

- Securities Intermediary
- Secured Party
- Debtor

DRAFTING ISSUES

- Identify Account – rep that it is a securities account
- Rep that the institution holding the account is a securities intermediary
- Covenant that the securities account will be treated as a financial asset

DRAFTING ISSUES

- Covenant that the securities intermediary will follow instruction of secured party without further consent of the debtor
- No conditions to the right of secured party to issue entitlement orders
- No other control agreements

PRIORITY

- The general rule is that control takes priority over filing or other means - 9-328

CONCLUSION - QUESTIONS

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THANK YOU