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Distinguishing Between Securities Account and Deposit Accounts Under the UCC

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Lenders frequently take security interests in the deposit accounts and securities accounts of their borrowers to secure the repayment of borrowers' loan obligations. This article explores the basis for perfecting security interests in securities and deposit accounts and discusses the often important and sometimes elusive distinction between the two.

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Cash collateral accounts of one form or another are an important part of many finance transactions. These accounts may constitute significant assets of a borrower and can assume many forms, including operating accounts, capital subscription accounts, various types of reserve accounts and cash management accounts. These accounts may contain funds that are maintained overnight or for extended periods. More often than not, business realities dictate that the borrower be allowed to maintain some degree of control over the funds and invest them in financial assets rather than letting them languish as cash balances.

The question for lenders who typically take a pledge of these accounts to secure the loan obligations of their borrower is how to perfect their security interest. These lenders must confront the issue of whether these various accounts are deposit accounts or securities accounts under the Uniform Commercial Code, or maybe a little of both. Put another way, lender's counsel must determine where Article 9 of the UCC ends and Article 8 begins when dealing with such accounts, or whether the lender is out of the UCC altogether and in the realm of the common law.

Determining the nature of the account collateral

The first step of the analysis for purposes of determining how to perfect a lien is to decide what kind of collateral is involved. The analysis here revolves around determining whether a given account is a deposit or a securities account, as such terms are defined in the UCC in the relevant jurisdiction.

In some states, the distinction between deposit accounts and securities accounts is not meaningful for purposes of perfection. Illinois is one such state. In Illinois, deposit accounts are covered by the UCC and the steps for perfection are more than adequately covered by obtaining the appropriate account control agreement needed to perfect a security interest in a securities account under Article 8 of the UCC (discussed below).

Perfection of a security interest in a deposit account under Article 9 of the UCC in Illinois requires merely that the bank acknowledge and consent in writing to notice of the security interest. Section 9-302(1)(i)(ii). An effective account control agreement — one that confers upon the secured party the unilateral (though not

necessarily exclusive) right to control the disposition of the collateral — achieves this and more.

This is not the case in most states, however. In New York, for example, perfection of a security interest in a deposit account is governed by common law and requires sole dominion and control by the secured party over the deposit account. In such states (they are the majority until the effective date of revised Article 9) the distinction between deposit accounts and securities accounts becomes critical. And therein lies the rub.

Certain accounts can confidently be identified as deposit accounts. Others are clearly securities accounts. Many accounts, however, are less easily classified. The problem is best illustrated by a typical account in the context of a typical deal structure.

Assume, for example, that a borrower or some third party periodically deposits funds into an account subject to a pledge in favor of a lender. Thus, the cash balance in the account represents new money, not proceeds from existing financial assets. Assume further that the account is maintained with a bank and that the borrower is permitted to actively manage the account and direct investments in specifically delineated financial assets.

Also assume that although investments are permitted, the account is historically maintained as cash for short durations, measured in days, before being swept into some other account. Checks are periodically drawn against the account for permitted payments under the loan documents. Is this account a deposit account or a securities account? How should a lender perfect its security interests in such account?

Section 9-105(1)(e) of the UCC defines a deposit account as "a demand, time, savings, passbook or like account maintained with a bank," savings and loan association, credit union, or like organization. (The definition of deposit account is the same under the model UCC and under the UCC as adopted in Illinois.) This is the typical deposit account comprised of cash balances. Among its distinguishing characteristics are the accessibility and liquidity of the funds in the account. See, e.g., *Merrill Lynch, Pierce, Fenner & Smith , Inc. v Van Kylen*, 98 BR455 (WD Wis 1989). Unlike with a securities account, the relationship between the owner of a deposit account and bank is that of a debtor and creditor. The deposit account owner possesses a chose in action and not a property right in the money in the deposit account.

Section 8-501 of the UCC defines a securities account as "an account to which a financial asset is or *may be* credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset." Section 8-501(a) (emphasis added). The concept of a securities account is closely tied to the concept of a securities entitlement, which is defined as the rights and property interests of an entitlement holder with respect to a financial asset. Section 8-102(a)(17). The security interests granted to the lender in the securities account are in these security entitlements, not in the underlying financial assets themselves.

Indeed, the UCC recognizes that the underlying financial assets may be several accounts removed from the account at issue, an attribute of the indirect holding system prevalent in our financial markets. Section 8-501(c) also makes it clear that once a person acquires a securities entitlement as provided under 8-501(b) (discussed below), then he or she has a securities entitlement "even though the securities intermediary does not itself hold the financial asset."

Securities accounts and security entitlements

A securities entitlement is a bundle of property and contract rights held by the entitlement holder (i.e. the account owner) with respect to the securities intermediary and the financial assets credited to the account. A securities entitlement arises in the context of a securities account. It exists when a securities intermediary receives financial assets for the account of the entitlement holder or otherwise incurs the obligation to credit such account with a financial asset for the benefit of the entitlement holder. See section 8-501(b). Security entitlements, therefore, are essentially claims against the securities intermediary that maintains the securities account.

So, a securities account is the account to which a financial asset may be credited and a security entitlement is the collection of rights that accrue to the entitlement holder with respect to the financial assets credited to the securities account.

By obtaining a lien on the securities account, the secured party has a lien on all security entitlements in the account,

obviating the need to obtain individual liens on each financial asset credited to the securities account. Section 9-115(2) of the UCC provides that, "Attachment or perfection of a security interest in a securities account is also attachment or perfection of a security interest in all security entitlements carried in the securities account." This confers what is analogous to a floating lien on inventory. The contents of the account may change and the account owner can exercise control over the disposition of individual items in the account, but the secured party still enjoys a lien on the fluid contents of the account.

Perfection of security interests in accounts

Generally speaking, a lien on a securities account may be perfected in one of two ways; by filing a UCC financing statement or by obtaining control over the disposition of the financial assets credited to the account. See section 9-115(4). Filing might suffice in certain instances, but is vulnerable to being primed by someone who gains control. Section 9-115(5)(a).

Section 8-106(d) provides that control is achieved if the secured party becomes the entitlement holder or if the securities intermediary "has agreed that it will comply with entitlement orders originated by the [secured party] without further consent by the entitlement holder." The commentary makes clear that the economic test of whether a secured party has the requisite degree of control is whether the secured party "has the *present ability* to have the securities sold or transferred without further action by the transferor." Section 8-106, comment 7, emphasis added.

(This has implications for drafting the account control agreement. Take care that notice requirements or other conditions precedent to a lender's ability to issue entitlement orders do not rise to the level of interfering with the lender's present ability to unilaterally direct the disposition of the financial assets in the account. Such limits on the lender's discretion belong in the pledge agreement between borrower and lender. For this reason also, it is better, until Revised Article 9 and the conforming changes in Article 8 are in effect to keep the pledge and the account control agreement as separate documents.)

A deposit account is another matter. Other than in a handful of states, including Illinois, Hawaii, and California, deposit accounts are not covered by the UCC and are instead governed by common law. (Section 9-104 of the UCC excludes from its coverage transfers of interests in "deposit accounts" except to the extent that they constitute "proceeds" within the meaning of section 9-306 of the UCC.)

In New York, for example, perfection is achieved by exercising sole dominion and control in such a manner so as to make clear to third parties that the account owner does not control the account or the funds in it. This conservative standard is gleaned from case law not always in accord and therefore not free from doubt. Courts are divided, for instance, as to whether grants of security interests in deposit accounts are governed by the common law of pledge (which ordinarily requires delivery of the pledged property so as to put third parties on notice that the pledged property has been encumbered), or by the law of assignment (which ordinarily requires the complete transfer of dominion and control over the assigned property). Both are relatively vague and potentially problematic standards.

The idea of conferring complete dominion and control under the law of assignments is relatively clear in the context of an absolute assignment but becomes more uncertain for a conditional assignment in favor of a secured party, especially where the borrower retains some control over the account. Sole dominion and control is a rigorous standard and would appear to preclude active management of an account by the borrower. Thus, the notion of sole dominion and control may not be practical or consistent with the business deal.

The delivery requirement under the law of pledges, on the other hand, has been held to require delivery of the "indispensable instrument" embodying the rights in the deposit account. Where such an "indispensable instrument" does not exist, it is unclear as to whether a pledge can be effected.

In any event, the principles of providing notice to third parties that the subject property is encumbered, and divesting the grantor of control over such property, emerge with some consistency from the case law and establish general guidelines for lenders to perfect their security interests in deposit accounts under the common law.

When in Rome…different standards for different states

So, what should a lender do with respect to the hypothetical account described earlier? If the account and the debtor

are both located in Illinois there is no problem. Our secured party should obtain an account control agreement and give it little more thought.

By being located in Illinois, I assume for sake of simplicity that the securities intermediary's jurisdiction, as stipulated in the account control agreement, is in Illinois. The parties are free under Article 8 to chose any jurisdiction and are not constrained by the actual situs of the account. This choice of law principle is less clear, however, with respect to deposit accounts, since the revisions to Article 9 of the Illinois UCC that added deposit accounts to its scope failed to add the corresponding choice of law provisions for such accounts. Therefore, unless both the debtor and the deposit account are located in Illinois, it is unclear whether the account is covered by the UCC in Illinois.

If the account, or the debtor, is located elsewhere, however, there may be a problem. The methods of perfection between deposit accounts and securities accounts may not be nearly as congruent as they are in Illinois and an account control agreement may not achieve the requisite degree of control to perfect under the common law. If there is doubt about the nature of the account, the lender should probably comply with the common law perfection requirements of the particular jurisdiction or risk being unperfected.

One novel approach to defeat the issue

One thought-provoking article suggested that Article 8 provided an effective means of circumventing the strictures and vagaries of the common law pledge with respect to deposit accounts. See Alan S. Dubin, "Security Interests in Cash Collateral Accounts Under the UCC," *Clarks' Secured Transactions Monthly*, Vol 15, No 9 (Nov 1999). Author Dubin devised a strategy to bring the deposit accounts at issue under Article 8 by making them subject to control agreements.

The inspiration behind his strategy was to enable him to render a relatively clean opinion letter for the perfection of a lender's security interests in certain deposit accounts, as required by lender's counsel. Dubin prepared an account control agreement, the terms of which purported to transform all deposit accounts into financial assets by mutual declaration of the securities intermediary and account owner pursuant to section 8-102(a)(9)(iii) of the UCC. This section, which permits the securities intermediary and account owner to agree that any property held in the account should be deemed to be a financial asset, is discussed below.

The threshold questions upon which this strategy rests, according to Dubin, are (i) could money be a financial asset and (ii) could the commercial bank at which the collateral accounts were maintained act as a securities intermediary and invest funds into deposit accounts held in a securities account? Essentially, he proposed that the borrower open a securities account (with a brokerage or a bank which maintains securities accounts in its normal course of business), direct the securities intermediary to make "investments" in deposit accounts (maintained with an affiliate bank), and agree with the securities intermediary that such deposit accounts are financial assets. Nothing on the face of the UCC would appear to prohibit such a maneuver, and on this basis our practitioner issued a relatively clean, unqualified opinion (as opposed to the reasoned opinion typically seen with respect to common law perfection).

Is money a financial asset?

Before addressing the viability of Dubin's proposed strategy, we should examine the first issue he raised and dispose of it. In so doing we will see that it does not really advance the analysis but rather takes us on a side journey, albeit an instructive one.

The question of whether money can be a financial asset begs the question of what "money" is. Money under the code is defined as a "medium of exchange authorized or adopted by a domestic or foreign government and includes a monetary unit of account." We typically think of it as being in the form of cash or currency. Perfection is achieved only through possession, usually implying cash. Section 9-304. (Whether or not cash itself can be a financial asset is not entirely clear from the UCC definitions. Interestingly, while the relevant sections are the same as between the Illinois UCC and the model UCC, the Illinois UCC commentary clearly includes cash as a financial asset where the model UCC makes no mention of it.)

The problem is that deposit accounts typically do not contain cash. Cash balances in an account are actually instead a claim against the financial intermediary. Moreover, in the case of securities accounts, it is not the financial asset or the

investment property in which one perfects, as pointed out above, but rather the security entitlements within the securities account. Thus, to the extent a cash balance in a securities account represents a claim against the securities intermediary, such claim is a sort of entitlement in which a security interest can be perfected. The nature of money does not seem relevant to our analysis.

Furthermore, the UCC expressly contemplates the existence of cash balances in a securities account. The comments to section 9-115 of the code, which govern the methods of perfecting in investment property, provide in relevant part "[a] security interest in a securities account would also include all other rights of the debtor against the securities intermediary arising out of the securities account. For example, a security interest in a securities account would include credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement." Section 9-115, comment 4. Thus, capital contributions, rental income and the like, which are deposited to a securities account (if in fact the account at issue is a securities account) would be covered by the lien of the lender and such lien would be perfected as regards such cash balances.

Therefore, the presence of a cash balance in an account or the characterization of such cash balance as being or as not being a financial asset is simply not relevant to the analysis of whether Article 8 governs the subject account. The proper inquiry is with respect to the nature of the account. The money question is, to a large extent, a red herring.

Can deposit accounts be a financial asset?

This leaves us with the second issue posited by Dubin, i.e., whether a commercial bank can be a securities intermediary and hold assets in a securities account in the form of deposit accounts. In other words, can a deposit account be a financial asset? More specifically, can one transform a deposit account into a securities account merely by directing a commercial bank to "invest the money in demand deposits" and stipulate by agreement that such demand accounts constitute financial assets?

This is a two-pronged issue, the first part being whether a commercial bank can be a securities intermediary. Of this there is little doubt. The definition of securities intermediary found at section 8-102(a)(14) specifically includes a bank. Furthermore, the nature of the institution, like the classification of money, should not normally be a dispositive factor in deciding whether an account qualified as a securities account. Accounts and financial institutions may not lend themselves to easy characterization. With the advent of the Gramm-Leach Financial Services Modernization Act and continuing financial innovation, the distinction between various types of accounts and between institutions will only blur more. Given the intent of the UCC to accommodate modern practice and future financial developments, distinctions of this nature should become less significant.

The second prong finally reaches the key issue: can a deposit account be a financial asset? Section 8-102(a)(9) of the UCC defines a financial asset as a security or "an obligation of a person or a share, participation, or other interest in a person or in property or an enterprise of a person, which is, or is of a type, dealt in or traded on financial markets, or which is recognized in any area in which it is issued or dealt in as medium for investment."

The definition in section 8-102(a)(9) contains a third category, upon which the aforementioned practitioner relies and which is the linchpin of his strategy. It goes on to say that a financial asset is "any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article." Section 8-102(a)(9)(iii).

Caveats and conclusions

Whether section 8-102(a)(9)(iii) of the UCC was intended to be as enabling and broad as its language suggests is open to debate. Read literally, section 8-102(a)(9)(iii) could be used to defeat the local recording requirements of real property, for instance. Just as one can perfect a security interest under Article 8 in capital stock by depositing a stock certificate evidencing ownership of such capital stock with the securities intermediary (endorsed in blank or to the intermediary), one could also perfect a security interest in real property by depositing a deed for it with a securities intermediary and agreeing to treat the deed as a financial asset, thereby allowing a secured creditor to perfect its security interests wholly independently of the local real estate records. Certainly this could not have been intended by the drafters of the UCC.

A more reasonable interpretation of section 8-102(a)(9)(iii) is that it was never intended to apply to items not within the purview of the UCC to begin with. But this leads us back to where we began, because other than in a few states, deposit accounts are not covered by the UCC.

Whether a deposit account can be a financial asset as Dubin argues is an open question at best. A simpler approach than the one he advocates may have been simply to establish a securities account with checking features and some liquid short term investments, thereby avoiding the issue of deposit accounts as much as possible. (Note that the UCC in its prefatory notes warns that separate bank accounts linked to securities accounts are not securities accounts by virtue of such linkage and are governed by law other than the UCC.)

Recall that a securities account is defined as "an account to which a financial asset is *or may be credited*...". Arguably, the mere ability to make and hold investments in financial assets transforms the character of the account from a deposit account into a securities account.

Of course, adding "permitted investment" provisions to an account agreement (governing what would otherwise be a deposit account) as mere window dressing for purposes of bringing it within the ambit of Article 8 may not win the respect of a court. One would expect a court to look to the intent of the parties, the nature of the financial institution at which the account is maintained, the relation of the institution and the account holder, industry practice, the history of actual investments in the subject account, and similar factors in determining whether the transformation from deposit account to securities account was real or illusory. Courts do, however, appear reticent to expand the deposit account exclusion from the scope of the UCC and this suggests that such exclusion will be narrowly construed (see the *Merrill Lynch* case cited above).

None of this is to say that opening an account with a commercial bank, directing the funds in the account to be "invested" in deposit accounts, and agreeing that such deposits shall be deemed a financial asset would not withstand the scrutiny of the courts. But the area is murky and counsel representing lenders and opinion givers alike should be wary — at least until July of 2001.

Under revised Article 9, deposit accounts will be included under the UCC and perfection can be achieved only by obtaining control. The distinction between deposit accounts and securities accounts for perfection purposes will, at that point in time, become moot. In the meantime, dressing what would otherwise be a deposit account in the garb of a securities account should give little comfort to lenders' lawyers or opinion givers.

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