**GOLDBERG, KOHN, BELL, BLACK,
ROSENBLOOM & MORITZ, LTD.**

ATTORNEYS AT LAW

JANUARY, 2001

REVISED ARTICLE 9:
Summary and Analysis

One in a Series of Continuing Reports

DEPOSIT ACCOUNTS: NEW COLLATERAL CATEGORY, NEW FINANCE OPPORTUNITIES

INTRODUCTION

As highlighted in previous newsletters, one of the dominant policy objectives of Revised Article 9 of the Uniform Commercial Code is to expand the scope of covered properties and interests in properties, thereby promoting legal certainty and generating new finance opportunities. Perhaps nowhere is this objective better illustrated than in the case of deposit accounts, a collateral category largely ignored by Current Article 9, and insufficiently developed where treated. Revised Article 9 makes substantial improvements to the rules governing security interests in deposit accounts, especially with respect to perfection and priority contests. However, given the highly liquid and fungible nature of funds withdrawn from deposit accounts, as well as the special role depository banks play in commercial finance, Revised Article 9 also sets forth a number of complex rules specific to the topic, which must be fully understood by anyone desiring to obtain a perfected security interest in this new class of Revised Article 9 collateral.

CURRENT LAW

A brief summary of current law provides helpful context. Current Article 9, as adopted by a strong majority of jurisdictions (excluding Illinois, as discussed below), excludes deposit accounts as original collateral subject to the UCC. See C9-104(l). As a result, under the laws of most states, a secured creditor desiring to take a lien on a deposit account as original collateral must look at that state's common law to determine the appropriate method of perfection. The difficulties of the current system are summed up by official comment no. 16 to R9-109, which states in part: "The common law is nonuniform, often difficult to discover and comprehend, and frequently costly to implement. As a consequence, debtors who wished to use deposit accounts as collateral sometimes were precluded from doing so as a practical matter." As a consequence, the exclusion of deposit accounts from the UCC as original collateral has significantly reduced finance opportunities.

While excluding deposit accounts as original collateral, Current Article 9 does extend coverage to deposit accounts to the extent that they constitute proceeds of original collateral. See C9-306(1). So, for example, while a secured lender, following Current Article 9 rules, could not directly perfect a security interest in a deposit account, that same lender could, subject to certain limitations and to various tracing rules discussed below, reach into a deposit account as a perfect secured creditor to claim an interest in cash proceeds of assets that once served as properly perfected collateral, such as accounts receivable or inventory. See C9-306(3). This lien on proceeds is limited to "identifiable cash proceeds", a clause specified, but not directly defined, in Current Article 9. Since typical bank accounts often will contain cash from sources other than the proceeds of original collateral, the courts have had to establish rules to determine what constitutes "identifiable cash proceeds". A majority of states have adopted the "lowest intermediate balance" rule to identify proceeds. This rule assumes that an account holder will spend his or her own money prior to spending the proceeds in which a secured party has an interest. In applying this rule, a court will initially determine the proceeds originally received by a debtor upon disposition of original collateral, and will then determine the lowest balance in the account during the relevant period. The "identifiable cash proceeds" will be equal to the lesser of the proceeds received by the debtor and deposited in the account and the lowest balance in the account during the relevant period.

As mentioned above, a few states, including Illinois, have adopted non-uniform UCC amendments in order to provide for direct perfection against deposit accounts. The rules in these states differ slightly, though all defer to a private method of perfection over a form of public perfection, such as the filing of a UCC financing statement. The Illinois Uniform Commercial Code provides that, when a deposit account is maintained with the secured party, the secured party will obtain a perfected security interest in the deposit account upon execution of a security agreement by the debtor which covers the deposit account. When a deposit account is maintained with a third party, a secured party may perfect a security interest covering a deposit account by notifying the depository bank of the security interest and by receiving an acknowledgment and consent to its security interest from the applicable depository bank. See IL C9-301(i)(ii). Other states, such as California, only require notice be given to the depository bank and do not require its acknowledgment or consent.

While having the advantage of bringing bank deposit accounts within Article 9 as original collateral, the minority position in Illinois, California and a few other jurisdictions has been only a partial fix for secured creditors. For example, the Uniform Commercial Codes in these jurisdictions do not address priority contests between a lien creditor with a claim against a deposit account as original collateral and another lien creditor claiming an interest in bank deposits as proceeds of other collateral. Note that the general rule of first to file or perfect, in this context, does not necessarily lead to a clear answer. For example, consider a contest between two secured creditors: one which has a perfected security interest in a deposit account as original collateral and another which has perfected its security interest in collateral (say, for instance, inventory) which has been replaced with identifiable cash proceeds. Given that (i) the two creditors are claiming interests in two different categories of original collateral (deposit accounts vs. inventory) and (ii) only one of the creditors will have perfected through a public act (the filing of a financing statement, in the case of an inventory financier), the timing of perfection in a contest between these two creditors doesn't appear to be a clear guide.

REVISED ARTICLE 9

Generally

Before discussing the new perfection rules pertaining to deposit accounts, it is important to clearly delineate the scope of this new collateral category. First, note that Revised Article 9 does not expressly state that deposit accounts may serve as original collateral. Instead, the inference is derived from R9-109(a)(1), which provides as a general rule that, subject to certain specified exclusions, Revised Article 9 applies to any transaction "regardless of its form, that creates a security interest in personal property…" The inference that bank accounts may service as covered personal property under R-109(a)(1) is further solidified by an important exclusion. R9-109(d)(13) provides that Revised Article 9 does not apply to "an assignment of a deposit account in a consumer transaction", except with respect to proceeds thereof, thereby allowing one to conclude that deposit accounts in commercial (as opposed to consumer) transactions may serve as original collateral, which is indeed affirmatively stated in official comment no. 16 to R9-109. Before moving to what is, and what is not, a "deposit account", it is therefore important to recognize that such accounts arising in connection with consumer transactions (defined formally at R9-102(a)(26)) are excluded from coverage as original collateral.

Revised Article 9 defines "deposit account" as "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." R9-102(a)(29). First, note the limitation placed on the custodian of the account. It must be a bank, which is defined under Revised Article 9 as "an organization that is engaged in the business of banking. The term includes savings banks, savings and loan associations, credit unions, and trust companies." R9-102(a)(8). Accounts maintained with other institutional money managers, including money market accounts which often function just like bank checking accounts, are therefore excluded from the rules discussed in this article; these and other brokerage accounts receive coverage under Revised Article 9 as "investment property", with perfection rules provided under R9-106 and R9-314. While the rules governing perfection in deposit accounts and investment property both use the concept of "control", discussed at some detail below, there is one critical difference in the overall UCC treatment. In the case of investment property, the UCC permits the filing of a UCC financing statement as a method of perfection. In the case of deposit accounts, such filings have no legal effect. As such, it is essential for a secured creditor to identify the legal form of the party maintaining an account, as the method of perfection may change accordingly.

As stated above, the defined term "deposit account" explicitly excludes accounts evidenced by instruments. This exclusion was specifically designed to help clarify

the topic of perfection against certificates of deposit. As explained by official comment no. 12 to R9-102, under this definition certificates of deposit will be treated as deposit accounts unless they qualify as "instruments" under Revised Article 9, in which case they become subject to the perfection rules set forth at R9-304.

Attachment

The bedrock attachment requirements remain intact with respect to deposit accounts serving as original collateral. As is the case with Current Article 9, a security interest attaches only when value is given by the secured party, the debtor has rights in the collateral and the debtor has the power to transfer such rights. R9-203. Additionally, the debtor must have either "authenticated a security agreement that provides a description of the collateral" or the secured party has must have obtained "control" pursuant to a security agreement. See R9-203. The concept of "control" will be explored more fully below in the context of perfection rules. For present purposes, it should be noted that, in situations where a security interest arises under a security agreement, that agreement must provide a description of the collateral. Official comment no. 16 specifies that, inasmuch as deposit accounts are a distinct category of collateral under Revised Article 9, they must be separately identified (either individually or categorically) in a security agreement – they will not fall within the catchall rubric of general intangibles. The same conclusion may be reached under R9-108, which sets forth general rules regarding the sufficiency of descriptions in security agreements.

Perfection on Deposit Accounts as Original Collateral

Under Revised Article 9, a security interest in a deposit account serving as original collateral may be perfected only by control. R9-312(b)(1). This concept of "control" derives from the rules of perfection applicable to investment property, where "control", as specifically defined, is a superior, but not exclusive, method of perfection. In the case of deposit accounts, "control" has been given its own unique definition, set forth at R9-104, and is the exclusive method of perfection.

R9-104 provides for three ways to obtain control of a deposit account. First, control is achieved where "the secured party is the bank with which the deposit account is maintained." R9-104(a)(1). Depository banks, as a consequence, always have automatic perfection, with no requirement of public notice or other disclosure. Revised Article 9 further gives depository banks heightened priority rights, subject only to the rights of another secured creditor which has perfected its lien by becoming the bank customer. R9-327(3) and (4). To assure its lien position, therefore, a secured creditor taking an interest in a deposit account by means of a control agreement, discussed next, will always want to insist that the depository bank either waive or subordinate its automatically perfected security interest.

The second method of obtaining control is for the debtor, the secured creditor and the bank to enter into a tri-party agreement pursuant to which "the 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". R9-104(a)(2). As explained at official comment no. 3, the key to this method of obtaining control is that the debtor must be deprived of all consent rights with respect to disposition of funds. However, the bank's obligation to comply with disposition instructions may itself be conditioned by other events and/or deliveries, such as a certification by the secured creditor that the debtor is in default. Further, the debtor's right to make transfers in and out of the deposit account, absent election by the secured creditor to control disposition, will not invalidate the secured creditor's present control over the account. This tri-party agreement is also the natural vehicle for subordinating or waving a bank's control status under R9-104(a)(1). Finally, note two important rules protecting bank interests with respect to control agreements, set forth at R9-342. First, this section states that Revised Article 9 does not require a bank to enter into a control agreement, even if its customer so requests or directs. The bank can just say no. Second, a bank that enters into a control agreement "is not required to confirm the existence of the agreement to another person unless requested to do so by its customer." If a secured creditor desires information from a bank regarding previously executed control agreements, it should therefore cause its debtor to request that information from the bank, for the benefit of the secured creditor.

A final method of obtaining control is for the secured creditor to become the bank's customer with respect to the deposit account. R9-104(a)(3). As explained by official comment no. 3 to this code section, becoming the bank's customer on the account gives the secured creditor general rights afforded bank customers under Article 4 of the UCC. This method of obtaining control also has the unique advantage of priming a depository bank's automatic control rights under R9-104(a)(1). See R9-327(4). There may be potential costs to achieving

control through this method. First, by becoming the bank's customer on the account, the secured creditor may unintentionally restrict the debtor's routine access to account funds. Additionally, the secured creditor may, depending on how the account is structured, incur tax liability for earnings on the account, at least for the period of time in which it is named as the bank customer.

Perfection on Deposit Account as Proceeds

As under Current Article 9, Revised Article 9 provides that a secured party maintains its perfected security interest in the identifiable cash proceeds of collateral in which it has a perfected security interest. R9-315. R9-315(b)(2) states that proceeds, other than goods, are identifiable "to the extent the secured party identifies the proceeds by a method of tracing, including application of equitable principles, that is permitted under law other than" Revised Article 9. Official comment no. 3 to R9-315 states that the lowest intermediate balance rule is one, though not necessarily the exclusive, equitable principle which may be used to identify proceeds. Revised Article 9, therefore, stops just short of codifying the common law lowest intermediate balance rule.

Priorities of Competing Security Interests

Revised Article 9 sets forth clear rules to determine priority among competing secured parties claiming an interest in the same deposit account. The easiest starting place is R9-322(a)(2), which restates the basic rule under Current Article 9 that a perfected security interest has priority over a conflicting unperfected security interest. Section R9-327 next addresses the claims of two perfected secured creditors each claiming an interest in the same deposit account. The first rule in this section provides that a security interest held by a secured creditor having control over a deposit account will have priority over a conflicting security interest held by a secured creditor that does not have control. R9-327(1). In situations where both secured creditors have obtained their security interest in the deposit account as original collateral, this result is consistent with the general principle that a perfected security interest will prevail over an unperfected security interest, since control is necessary to perfect a security interest in a deposit account as original collateral.

Importantly, R9-327(1) also governs priority contests between a secured creditor having a perfected security interest in a deposit account as original collateral and another secured party holding a perfected security interest in the same deposit account as proceeds of other collateral. In this case as well, R9-327(1) sets forth a bright line test giving priority rights to the secured party having control of the deposit account. The general policy goal, as discussed at official comment no. 3, is to reward the creditor that has insisted, by obtaining control, upon the right to immediate access to a deposit account following default. At least in this limited context, private contractual arrangements, as among the debtor, a secured creditor and the depository bank, are afforded higher supremacy under Revised Article 9 than the public act of filing a financing statement. To summarize, a secured party with a properly perfected security interest in a deposit account as original collateral will always prevail over a secured party with a perfected security interest in a deposit account as proceeds.

In the rare case when two secured parties both have control of a deposit account, the first secured party to have obtained control will prevail. R9-327(2). However, the official comment to R9-327 points out that in this situation if the "bank is solvent and the control agreements are well drafted, the bank will be liable to each secured party, and the priority rule will have no practical effect."

As mentioned above, Revised Article 9 gives special priority rights to a depository bank. The general rule is that the depository bank will prevail against any other secured party. R9-327(3) and R9-340. There are only two ways a secured party can defeat the claims of a depository bank. First, as mentioned above, the secured party would prevail over the bank if the secured party perfects by becoming the bank's customer. R9-327(4). Second, the secured party can protect its rights by having the bank subordinate or waive its interests in the deposit account. See R9-339.

The rule determining priority between two secured parties with a perfected security interest in a deposit account as proceeds has also not changed under Revised Article 9. In that situation, the first secured party to have filed or perfected on the original collateral wins. R9-322(a)(1).

Proceeds of Deposit Accounts

What happens to a secured party's security interest in a deposit account when the funds on deposit are withdrawn? Revised Article 9 provides a set of rules governing rights with respect to the proceeds of deposit accounts. The ground rule is driven by the important policy objective of preserving the free negotiability of deposit account funds. Set forth at R9-332(b), this rule

provides that a third-party recipient of deposit account funds takes free and clear of any security interests in the deposit account unless "the transferee acts in collusion with the debtor in violating the rights of the secured party."

R9-322(c) provides a special priority rule with respect to proceeds of deposit accounts. It provides, as a general rule, that a security interest that enjoys priority status over other security interests under R9-327 (i.e. perfection through control) also has priority over conflicting security interests in proceeds of that collateral, so long as (i) the security interest in proceeds is perfected, (ii) the proceeds are cash proceeds or of the same type as the collateral and (iii) in the case of proceeds of proceeds, all intervening proceeds are cash proceeds, proceeds of the same type as the collateral, or an account relating to the collateral. Revised Article 9 does not formally define what is meant by proceeds "of the same type as the collateral", although official comment no. 8 to R9-322 states that the clause "should be read broadly." By way of example, the official comments state that "a security is 'of the same type' as a security entitlement (i.e., investment property), and a promissory note is 'of the same type' as a draft (i.e., an instrument)."

An example may help clarify. Assume that a secured creditor (SP1) has obtained a perfected security interest, via a control agreement, in a deposit account of its debtor (D). D has also arranged for inventory financing from another secured creditor (SP2), which has a properly perfected security interest in all of D's inventory. Assume D sells certain inventory, and deposits the resulting cash into its deposit account. Even assuming that the inventory sales proceeds are readily traceable to the deposit account, SP1 will have a priority claim against the account deposits, pursuant to R9-327(1), discussed above. Now assume that D withdraws cash from the deposit account, and uses that cash to repay obligations owing to SP2. While SP2 may not have priority vis-à-vis the deposit account, under R9-332(b), SP2 may take the cash transfer free and clear of any security interests in the deposit account, assuming that it did not act in collusion with D in violating SP1's interests.

Now assume that, instead of making a cash withdrawal, D arranges for the issuance by its depository bank of a non-negotiable certificate of deposit in exchange for funds on deposit. In this case, R9-322(c) will give SP1 a priority interest in the certificate of deposit. By virtue of (i) SP1's first lien position on the deposit account, through control, (ii) SP1's perfected interest in the proceeds (obtained, at least temporarily, through the operation of R9-315(c) and (d), which provide for automatic, yet potentially temporary, perfection in proceeds of original collateral) and (iii) the proceeds being the "same type" as the original collateral, R9-322(c) creates a special priority right in favor of SP1. This right will continue even upon disposition of the certificate of deposit, so long as the resulting proceeds are either themselves of the "same type" as the original collateral, or an account receivable related to the collateral. 9-322(c)(2)(C).

A different rule applies, however, when the proceeds are not the "same type" as the original collateral. For example, assume that D used funds in the deposit account to purchase more inventory. Because inventory is clearly not the "same type" as the original deposit account collateral, R9-322(c) will not govern priority contests with respect to the inventory. Instead, R9-322(d) supplies the answer, this time in favor of SP2. R9-322(d) and (f) provide that (i) where a security interest in a deposit account (among other collateral types) is perfected by a method other than filing, and (ii) where resulting proceeds are not cash proceeds, chattel paper, negotiable documents, instruments, investment property or letter-of-credit rights, conflicting perfected security interests in such proceeds rank according to priority in time of filing.

In our example, SP1 perfected its interest in the deposit account through a control agreement. Under R9-315, SP1 will have the opportunity to trace its interest in the deposit account to the newly acquired inventory. Assuming that tracing is successful, R9-315 will give SP1 a perfected security interest in the inventory for at least a 20 day period. However, assuming that SP2 has filed a proper UCC financing statement to perfect its lien on D's inventory, SP2 will defeat any interest claimed by SP1 through the operation of R9-322(d).

The applicability of R9-322(c) ends upon the disposition of proceeds giving rise to new proceeds which are not cash, the "same type" as the original collateral or an account. So, consider a scenario in which D keeps converting the proceeds of the certificate of deposit into "same type" proceeds or an account. R9-332(c) will protect SP1's interests. However, should there be any break in the continuity, even if "same type" proceeds should thereafter arise, R9-322(c) ceases to apply. To illustrate, if D, therefore, disposes of the certificate in exchange for a promise to pay money (an account receivable), which is thereafter exchanged for inventory, which is thereafter sold for cash, the intervening inventory makes R9-322(c) inapplicable. Who, therefore, would have a claim against the cash? Note in

this case that R-322(d) is equally inapplicable, as the final proceeds, cash, are excluded from R-322(d) pursuant to R9-322(e). Since no special priority rule applies, the general rules of R9-322(a) and (b) will govern, which resolve conflicting priority claims "according to priority in time of filing or perfection." In this case, therefore, SP1, which perfected by control, may defeat the claim of SP2, so long as it can establish that it perfected its interest in the deposit account prior to SP2's perfection against D's inventory. (See, e.g. Example 13 to official comment no. 9 to R9-322.

As a last wrinkle, what happens if D were to take the resulting cash and deposit it back into the original bank account. In this case, SP1 prevails. R9-322(f) provides that the special priority rules discussed above are, among other things, subject to "other provisions" Revised Article 9. As stated in official comment no. 8 to R9-322, one of these "other provisions" is R9-327, which confers priority status to the creditor that perfects by control. Because SP1 has control over the deposit account, it will prevail in any contest raised by another creditor claiming an interest in the account as proceeds, at least where the other creditor does not have control.

Choice of Law

R9-304 sets forth special choice of law provisions with respect to perfection and priority of security interests in deposit accounts. The importance of these rules will turn in large part on the roll-out of Revised Article 9. If all states concurrently adopt Revised Article 9 without any non-conforming amendments (at least with respect to interests in deposit accounts), the choice of law should be irrelevant with respect to perfection and priority. However, should there be a gap in time of adoption of Revised Article 9, or should one or more states adopt material non-conforming amendments on this topic, it will be important to understand Revised Article 9's choice of law rules.

The general rule here is that the local law of the bank which maintains the deposit account governs perfection and priority matters. R9-304(a). R9-304(b) then sets forth rules for determining a bank's jurisdiction. First, this section looks to the choice of the parties. If an agreement between the bank and the debtor sets forth a jurisdiction to govern the deposit account for purposes of Revised Article 9, that jurisdiction will be deemed to be the bank's jurisdiction. R9-304(b)(1). If there is an agreement between the bank and the debtor and the agreement does not specify a jurisdiction to govern with respect to Revised Article 9 but the agreement provides that the law of a particular jurisdiction will govern the agreement generally, then that jurisdiction will be deemed to be the bank's jurisdiction. R9-304(b)(2). Official comment no. 2 to R9-304 states that "[t]he parties' choice is effective, even if the jurisdiction whose law is chosen bears no relationship to the parties or the transaction."

If the parties have not chosen applicable law in an agreement, but there is an agreement between the bank and the debtor which provides that the account is maintained at a particular office, R9-304(b)(3) provides that the jurisdiction in which that office is located shall be deemed to be the bank's jurisdiction. If the agreement does not provide any of these things or if there is no agreement between the bank and the debtor, then the bank's jurisdiction shall be the jurisdiction in which the office listed on the account statement as the office serving the account shall be the bank's jurisdiction. R9-304(b)(4). Finally, if none of the preceding situations apply, the bank's jurisdiction shall be the jurisdiction in which its chief executive office is located. R9-304(b)(5).