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Securing Cash in Deposit Accounts: Common Pitfalls and Best Practices

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Article 9 of the Uniform Commercial Code (UCC) affords numerous protections to creditors who secure their loans with a debtor's deposit account. Article 9, however, contains numerous pitfalls for the unwary, which hinder a creditor's rights in a debtor's deposit account. This article will examine (1) the steps a creditor needs to take to protect its security interest in a deposit account, (2) dangers associated with purchasing accounts receivable and (3) a summary of the best practices to protect a security interest in a deposit account.

Perfecting a Security Interest in a Deposit Account

Under UCC Section 9-312(b), a security interest in a deposit account may be perfected only by "control." UCC Section 9-104 governs how a secured party obtains "control" over a deposit account and provides, in relevant part, that a secured party "controls" a deposit account if:

- (1) the secured party is the bank with which the deposit account is maintained;
- (2) the debtor, secured party, and bank have agreed in an authenticated record that 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; or
- (3) the secured party becomes the bank's customer with respect to the deposit account.

One exception to this general rule is if the secured party obtains a security interest in a deposit account as proceeds of other collateral. Under UCC Section 9-315, a security interest automatically attaches to any proceeds (i.e., anything obtained upon the disposition of collateral), and so long as the secured party's security interest in the original collateral was duly perfected, its automatically attaching security interest in the proceeds thereof will also be perfected.

Section 9-315 further provides that the secured party's security interest in the proceeds of collateral remains perfected indefinitely so long as the proceeds are "identifiable" proceeds, which generally requires that the proceeds, if commingled with other property, can be traced back to the original collateral subject to the secured party's perfected security interest. A deposit account can constitute identifiable proceeds of collateral, but secured parties should be wary of relying on this form of perfection. If the deposit account into which the proceeds of the secured party's primary collateral are deposited is a commingled deposit account that includes non-collateral funds, it can be difficult, and in some cases impossible, to clearly identify and segregate the secured party's collateral from the other funds. Furthermore, UCC Section 9-327 provides that a competing secured party's security interest in a deposit account that is perfected by control takes priority over any security interest in the deposit account that is not perfected by control, relegating the secured party relying on its perfected lien in the deposit account as proceeds to (at best) a second-priority position.

Purchasers of Accounts Receivable

While obtaining control of deposit account collateral is an important step in protecting a secured party's claim to the deposit account, in certain circumstances the UCC allows third parties to receive funds withdrawn from a deposit account free and clear of a secured party's perfected security interest – even if the secured party's security interest is perfected by control. One scenario where this can occur is in connection with the sale of accounts receivable. As explored further below, a prudent secured party should be aware of its debtors' accounts receivable sales and consider whether limiting or prohibiting the use of such arrangements is appropriate.

In a typical accounts receivable purchasing arrangement, a debtor will sell its accounts receivable to a third-party purchaser in exchange for accelerated cash payment of the receivable, net of the purchaser's fees and pricing margin. In some such arrangements, the purchaser will continue to allow account debtors obligated on purchased receivables to continue to remit payments to the debtor's deposit account, but will have a contractual right to periodically withdraw the proceeds of sold receivables directly from the debtor's deposit account.

This withdrawal right implicates UCC Section 9-332, which provides that a transferee of funds from a deposit account takes those funds free and clear of a secured party's security interest in the deposit account unless the transferee colludes with the debtor to violate the secured party's rights. This concept is critical for facilitating the use of deposit accounts in ordinary-course commerce, as it allows creditors to accept payments from deposit accounts without fear of having the funds clawed back by the payor's secured creditors. It is unfortunately also a trap for secured parties, particularly if the debtor quickly uses the accelerated cash proceeds to satisfy obligations to other creditors. Those creditors may also receive funds from the deposit account free and clear of the secured party's security interest courtesy of Section 9-332. It is therefore critical that a secured party understand its debtor's accounts receivable purchase arrangements if it is relying on accounts receivable and one or more deposit accounts as collateral.

Best Practices

A prudent secured party relying on a deposit account as collateral should take all necessary steps to obtain control over the deposit account in accordance with UCC Section 9-104. Where the secured party is also the depository maintaining the debtor's deposit account, the secured party's status as depository is sufficient to obtain control. If the secured party is not the depository, the secured party should obtain the depository's form of account control agreement to obtain contractual control over the deposit account and thereby perfect its security interest. Secured parties should also take care to understand their debtor's account receivables purchase arrangements and their impact on the secured party's collateral. Where appropriate, secured parties should consider adding restrictive covenants or default triggers to their transaction documents to prohibit the debtor from selling its accounts receivable without the secured party's prior written consent.