

DEPOSIT ACCOUNTS UNDER UCC

ARTICLE 9

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I. Deposit Accounts as Collateral under UCC Article 9

The most recent uniform version of Article 9 of the Uniform Commercial Code, approved by its sponsors in 1998, implemented a number of significant changes to the law of secured transactions. This paper discusses how this current version of Article 9 addresses various issues concerning security interests in deposit accounts. It also discusses how Article 9's treatment of security interests in deposit accounts touches upon issues that may come up in your bankruptcy practice.

A. Deposit Accounts as Collateral under Former Article 9

A deposit account is "a demand, time, savings, passbook, or similar account maintained with a bank." See UCC § 9-102(a)(29). A bank is defined as an "organization that is engaged in the business of banking [and includes] savings banks, savings and loan associations, credit unions, and trust companies." See UCC § 9-102(a)(8). Former UCC § 9-104(l) provided that Article 9 did not apply to a transfer of an interest in any deposit account, except with respect to proceeds and priorities in proceeds. Thus, under former Article 9, all deposit accounts, both commercial and consumer, were excluded as original collateral, leaving security interests in deposit accounts to be governed by the common law. The drafters of former Article 9 justified this exclusion by explaining that "such transactions are often quite special, do not fit easily under a general commercial statute and are adequately covered by existing law." See Official Comment 4 to former UCC § 9-104. This explanation for the exclusion is not very persuasive, and it has been suggested that the drafters excluded deposit accounts largely for political reasons due to strong opposition from banking interests. See Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 *Chicago-Kent L. Rev.* 963, 970 n. 23 (1999).

Several things should be noted about the treatment of deposit accounts under former Article 9. First, prior to the adoption of current Article 9, a few states had enacted non-uniform provisions that included deposit accounts in their versions of Article 9. See, e.g., Cal. Com. Code §§ 4210 & 9104 (1992); Haw. Rev. Stat. § 490:9-104 (1992); Idaho Code § 28-9-306 (Michie 1992); La. Rev. Stat. Ann. § 10:9-104 (West 1992). In addition, it was possible, though very difficult under the common law, for a party to take a security interest in a deposit account. For example, a party could pledge a deposit account by giving the pledgee possession of an indispensable instrument, such as a savings passbook, that entitled the holder to the balance of funds in the account. See *In re Housecraft Indus., USA, Inc.*, 155 B.R. 79 (Bankr. D. Vt. 1993). When the deposit account was not symbolized by an indispensable instrument, it was much more difficult to create a security interest in a deposit account. Courts did permit the creation

of a security interest in a deposit account where the depositor pledged or assigned the account, but the courts generally insisted that the pledgee or assignee have exclusive control and irrevocable authority over the deposit account. See Twin Land Group I, LLC v. Chicago Title Ins. Co., (In re Section 20 Land Group, Inc.), 261 B.R. 721 (Bankr. M.D. Fla. 2001) (court recognized a common law pledge of a deposit account where the power to draw on the account was with the creditor and not the debtor; did not matter that creditor could only draw on the funds for purposes set forth in the agreement); Miller v. Wells Fargo Bank Int'l Corp., 540 F.2d 548 (2d Cir. 1976) (assignor must be divested of control of time deposit for a valid assignment); In re Interstate Dep't Stores, Inc., 128 B.R. 703 (Bankr. N.D.N.Y. 1991) (creditor must have exclusive control for a valid pledge); Broadnax v. Prudential-Bache Secs., Inc. (In re Zimmerman), 69 B.R. 436 (Bankr. E.D. Wis. 1987). Any time a depositor reserves the right to make withdrawals from the deposit account, it would seem that there cannot be a valid pledge or assignment of the depositor's rights to that account. See Ellefson v. Centech Corp., 606 N.W.2d 324 (Iowa 2000) (possession required for a pledge does not exist if the debtor can use the funds in the ordinary course of the debtor's business); Duncan Box & Lumber Co. v. Applied Energies, Inc., 270 S.E.2d 140, 146 n. 11 (W. Va. 1980) ("In a bank account where the depositor has access to the account through withdrawal rights, it would be difficult, if not impossible, for the bank to demonstrate that the account constitutes a pledge in the absence of a showing that it has exclusive control over the account.").

It also should be noted that, while former Article 9 excluded all deposit accounts as original collateral, when proceeds were deposited in a deposit account, and those proceeds were "identifiable," the secured party had a right to those funds (just as they do under current Article 9). See Former UCC § 9-306(2). The UCC did not address the problem of determining which proceeds were "identifiable." Most courts applied the "lowest intermediate balance rule" in identifying proceeds that had been commingled in a deposit account. Under this rule, there is a presumption that proceeds of the sale of collateral remain in the account as long as the account balance equals or exceeds the amount of the proceeds. The funds are "identified" based on the assumption that the debtor spends his own money out of the account before he spends the funds encumbered by the security interest. If the account balance drops below the amount of the proceeds, the security interest in the funds on deposit is reduced accordingly. This lower balance is not increased if funds are later deposited into the account. See Ex parte Ala. Mobile Homes, Inc. 468 So.2d 156, 160 (Ala. 1985). In addition, so long as the proceeds were "identifiable cash proceeds," and if a financing statement covered the original collateral, no extra measures to continue perfection in the proceeds in the bank account were necessary. See Former UCC § 9-306(3).

B. Deposit Accounts as Collateral under Current Article 9

Article 9 does not state specifically that deposit accounts may now be used as original collateral. Instead, it broadly states that, with some specific exceptions, Article 9 applies to “a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.” See UCC § 9-109(a)(1). To the extent that a deposit account is “personal property,” it is presumptively within Article 9’s coverage. This is confirmed by Official Comment 16 to UCC § 9-109, which provides that “deposit accounts may be taken as original collateral under this Article.”

It should be noted, though, that UCC §9-109(d)(13) removes one type of deposit accounts, those arising in a “consumer transaction,” from Article 9’s coverage of original collateral. “Consumer transaction” is defined in UCC § 9-102(a)(26) as “a transaction in which (i) an individual incurs an obligation primarily for personal, family, or household purposes, (ii) a security interest secures the obligation, and (iii) the collateral is held or acquired primarily for personal, family, or household purposes. The term includes consumer-goods transactions.” Therefore, a “consumer transaction” requires both that the obligation be incurred primarily for personal, family or household purposes and that the collateral be held or acquired primarily for such purposes. If the financing is not obtained for consumer purposes or the deposit account is not a consumer account, Article 9 does permit a security interest in that deposit account as original collateral.

It has been suggested that this exclusion is the product of an unarticulated political compromise among creditors and consumer groups. See Steven D. Walt, *Underestimation Bias and the Regulation of Secured Consumer Debt*, 40 UCC L.J. 169 (2007). Cf. Jean Braucher, *Politics and Principle in the Drafting of UCC Consumer Protection Provisions*, 29 UCC L.J. 68, 70 (1996) (“Commercial interest groups have long used strong-arm tactics to get all, or much of, what they want in various UCC articles by using implicit or explicit threats along these lines: ‘Do it our way or we’ll lobby against you in the state legislatures.’ It is no surprise that consumer advocates have started to adopt the same winning strategy.”). The drafters might have been concerned about consumer creditors taking advantage of consumer ignorance about loan terms. As Professor Braucher has recognized, if Article 9 had been revised to permit consumer deposit accounts to be used as original collateral:

[C]onsumer creditors might have begun to use boilerplate to cover any deposit accounts as extra collateral in loans for cars or appliances or in personal lines of credit secured by particular deposit accounts or investment securities. Nonuniform state law has been burdensome enough to deter this sort of practice. If consumers did not realize that they were giving extra collateral, they would be unlikely to get price concessions or other

gains in exchange. Secured parties would have gained collateral in some instances, but it might well have been a windfall without any corresponding improvement in consumer welfare.

Jean Braucher, *Deadlock: Consumer Transactions Under Revised Article 9*, 73 Am. Bankr. L.J. 83, 94 (1999).

It should be noted, though, that Article 9 does contain several safeguards to prevent debtors from inadvertently encumbering deposit accounts and so reduce the likelihood that a secured party will realize a windfall from a debtor's deposit accounts. Because "deposit account" is a separate type of collateral, a security agreement covering general intangibles will not adequately describe deposit accounts; the security agreement must reasonably identify the deposit accounts that are the subject of the security interest (e.g., by using the term "deposit accounts"). See UCC §§ 9-102(a)(29), 9-108; see also UCC § 9-102(a)(2) and (4) (excluding deposit accounts from the "accounts" and "general intangible" categories). In addition, in order to perfect a security interest in a deposit account as original collateral, a secured party (other than the bank in which the deposit account is maintained) must obtain "control" of the account either by obtaining the bank's authenticated agreement or by becoming the bank's customer with respect to the deposit account. See UCC §§ 9-312(b)(1), 9-104. Either of these steps requires the debtor's consent.

A number of states have eliminated UCC 9-109(d)(13)'s exclusion of consumer deposit accounts. See, e.g., Idaho Code § 28-9-109(d); 810 Ill. Comp. Stat. 5/9-109(d); La. Rev. Stat. § 10:9-109(d); Miss. Code Ann. § 75-9-109(d); N.D. Cent. Code § 41-09-109(4); 12A Okla. Stat. § 1-9-109(d). It also should be remembered that this exclusion does not prevent a party from seeking to employ non-Article 9 methods to encumber a consumer deposit account (though the requirement that the secured party have exclusive control over the deposit account makes this very difficult), nor does it change existing law with respect to consumer deposit accounts to the extent that they constitute proceeds of other Article 9 collateral. See UCC § 9-109(d)(13). Just as under former Article 9, when proceeds of other Article 9 collateral are placed into a commercial or a consumer deposit account, a security interest attaches to those proceeds as long as they are "identifiable." See UCC § 9-315(a)(2). Most courts continue to apply the "lowest intermediate balance rule" in identifying proceeds.

II. Attachment of Security Interests in Deposit Accounts

Under UCC § 9-203(b), a security interest in a deposit account becomes enforceable if: (1) value has been given; (2) the debtor has rights in the collateral or the power to transfer

rights in the collateral to a secured party; and (3) the debtor has authenticated a security agreement that describes the collateral, or the collateral is in the possession of the secured party pursuant to the debtor's security agreement, or the secured party has control pursuant to the debtor's security agreement. In each case there must be a security agreement, but authentication is not required where the secured party has perfected by possession or control. This carries forward the rule of former UCC § 9-203 that possession pursuant to an agreement is a substitute for a written security agreement, and extends this concept to collateral subject to "control," such as deposit accounts pursuant to UCC § 9-104. Therefore, while a security agreement must exist, a secured party claiming a security interest in a deposit account over which the secured party has control need not obtain an authenticated security agreement covering the deposit account. As one writer has stated, "[t]he security agreement must exist but may be created orally, or through implication, course of dealing, a change in terms notice, or any other method sufficient to create a binding contract." Ben Carpenter, *Security Interests in Deposit Accounts and Certificates of Deposit Under Revised UCC Article 9*, 55 Consumer Fin. Q. Rep. 133, 137 (2001). As discussed earlier, Article 9 leaves largely unchanged the law under former Article 9 relating to the attachment of security interests in proceeds of collateral deposited into a deposit account—a security interest automatically attaches to any identifiable proceeds. See UCC § 9-315(a)(2).

III. Perfection of Security Interests in Deposit Accounts

A security interest in a deposit account as original collateral may be perfected only by obtaining control over the account. See UCC § 9-312(b)(1). There is no permissive filing provision (as there is, for example, with respect to investment property), so a UCC-1 financing statement covering deposit accounts will have no effect. Originally, those revising Article 9 had planned to allow permissive filing as to deposit accounts. See Proposed § 9-304 in Council Draft No. 1 (Nov. 17, 1995). But there was opposition from many bankruptcy attorneys to the whole concept of allowing an Article 9 security interest in the general bank accounts of the debtor, as it was feared that a floating lienor could insist on a security interest in all of the debtor's bank accounts, leaving even fewer resources for unsecured creditors or to support a reorganization. In response to these concerns, the drafters decided to require that a secured party establish control over the account to have an interest that will be effective in bankruptcy—a secured party is not able to obtain a perfected security interest in all of the debtor's bank accounts simply by filing a financing statement. As Professor Mooney explained to the 1996 Annual Meeting of the American Law Institute:

What this means is that many of the concerns expressed on the Drafting Committee and out of the Drafting Committee about the potential to simply throw deposit accounts

into a security agreement, file a financing statement covering everything and thereby, in effect, casting the slime of Article 9 over all of the liquid assets of the company is no longer there. What we have done is use this as a proxy for essentially only protecting those who are really reliance creditors who, as third parties, would go to the bank and take the time to get the bank's agreement in effect to attain. At our last Drafting Committee meeting, that seemed to reach a happy medium compromise which soothed some of the concerns people had about making it too easy to fix up bank accounts while at the same time protecting legitimate interests in a number of commercial transactions where this can be important.

See 73rd Annual Meeting, The American Law Institute, Proceedings 1996, at 475.

The requirements for obtaining control of a deposit account are set out in UCC § 9-104(a). That section provides that a secured party has control of a deposit account if; (1) the secured party is the bank with which the deposit account is maintained; (2) the debtor, the secured party, and the 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 account without further consent by the debtor; or (3) the secured party becomes the bank's customer with respect to the deposit account. In essence, a secured party has control when it is able to dispose of the deposit account without further cooperation from the depositor of record (the debtor). A secured party may have control over the deposit account even though the depositor-debtor retains the right to direct the disposition of funds from that account. See UCC § 9-104(b). Thus, if the secured party also is the depository bank, Article 9 provides for automatic perfection by control. If the secured party is not the depository bank, it may obtain control by either executing a control agreement authenticated by both the debtor and the depository bank, or by becoming the depository bank's customer with respect to the deposit account.

As a result of these provisions regarding control, it is quite easy for a depository bank to obtain an enforceable, perfected security interest in its depositor's deposit accounts. Control in that case does not require a control agreement or even an authenticated security agreement. While there must be a security agreement with the debtor, it need not be memorialized, and the depository bank need not bargain with any third parties.

On the other hand, it may be difficult for a secured creditor other than the depository bank to obtain a perfected security interest in a deposit account. In those cases, obtaining control over the deposit account requires the cooperation of the depository bank, which must either be a party to an authenticated control agreement, or must allow the secured creditor to become the owner of the deposit account. UCC § 9-342 makes clear that a depository bank is

not required to enter into a control agreement, even if it is directed to do so by the depositor. In addition, the bank may simply refuse to allow the secured creditor to become its customer of the deposit account. Certainly, where the depository bank itself has a security interest in a deposit account, it has little incentive to enter into a subordination agreement proposed by the secured creditor, except to risk the alienation of its customer.

It should be noted that model deposit account control agreement forms have been promulgated by the ABA Business Law Section's Joint Task Force on Deposit Account Control Agreements. The Initial Report of the Task Force as published by the Business Lawyer as well as the final version of the General Terms and Specific Terms of the Deposit Account Control Agreement can be accessed at <http://www.abanet.org/dch/committee.cfm?com=CL710060>. The Task Force has also approved several Inserts to be used with the model agreement: the Standing Disposition Instruction Insert (i.e., for sweep accounts), the Lock Bock Insert, the Non-Demand Deposit Account Insert, the Initial Block without Standing Disposition Instruction Insert, the Time Deposit Insert, and the Deposit Account Automatic Sweep Investment Insert, all also assessable on the website noted above.

Article 9 also carries forward the rule under former Article 9 that perfection in the original collateral suffices for perfection in the proceeds, at least for twenty days. See UCC § 9-315(c) and (e). The security interest becomes unperfected on the twenty-first day after attachment in the proceeds unless, among other things, the proceeds are identifiable cash proceeds. See UCC § 9-315(d)(2). Because deposit accounts are "cash proceeds" as defined in UCC § 9-102(a)(9), nothing need be done to continue perfection.

IV. Priority Between Conflicting Security Interests in a Deposit Account

UCC § 9-327 sets out the rules for determining priority among conflicting security interests in the same deposit account. These rules govern priority disputes in deposit accounts claimed as original collateral as well as security interests claimed as proceeds of Article 9 collateral.

Under the general priority rule governing deposit accounts as original collateral, perfected security interests rank according to the order in which control in the accounts is obtained. See UCC § 9-327(2). That is, under the general rule, the first to obtain control has priority. But two exceptions to this general priority rule favor depository banks that have a security interest in accounts that they maintain. First, a bank that has control because it maintains the deposit account has priority over all other secured parties with control except a secured party who has obtained control by putting the deposit account in its name. See UCC §

9-327((3)). Therefore, a depository bank has priority in deposit accounts it maintains even if it obtained control of those accounts after a competing secured party obtained control. The second exception gives secured parties priority over depository banks if they obtain control by becoming customers of the bank with respect to the deposit accounts that the bank maintains. See UCC § 9-327(4). As discussed earlier, depository banks may simply refuse to allow these other secured parties to become their customers, so they will need to bargain with the depository banks for priority. Unless the depository banks agree to the secured parties becoming their customers, the banks have priority in the deposit accounts that they maintain.

V. Priority to Proceeds of Other Article 9 Collateral Deposited into Deposit Account

As discussed earlier, when proceeds of other Article 9 collateral are placed into a deposit account, a security interest attaches to those proceeds as long as they are identifiable. See UCC § 9-315(a)(2). Perfection as to the original collateral suffices for perfection as to these cash proceeds. See UCC § 9-315(c) and (d). UCC § 9-327(1) addresses the issue of priority when these cash proceeds are placed into a deposit account in which another secured party has a security interest that has been perfected by control.

UCC § 9-327(1) provides that a security interest held by a party having control of the deposit account has priority over a conflicting security interest held by a secured party that does not have control. This is true even if the party holding the conflicting security interest was the first to file or perfect, or that party had a purchase money security interest in the original collateral, and so would ordinarily have the special purchase money security interest priority in cash proceeds provided for in UCC § 9-324(a) and (b).

For example, assume that Seller sells a piece of equipment to Debtor on credit, and retains a purchase money security interest, which Seller immediately perfects by filing a financing statement. Debtor then sells the equipment for cash, and deposits this cash in his deposit account at Bank. Seller likely assumes that if Debtor defaults in its payments, Seller would have priority to these cash proceeds, so long as they are identifiable. But UCC § 9-324(a) provides that the purchase money priority in proceeds is subject to UCC § 9-327, so that if Bank has a security interest in the deposit account that is perfected by control (which is automatic), Bank would have priority to these proceeds.

Is there any way for Seller to protect itself in the above situation? First, it may be difficult for Seller to even determine whether Debtor has entered into a control agreement. Under UCC § 9-342, a bank that has entered 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.” Official Comment 2 to UCC § 9-342 explains that this is to protect banks “from the need to respond to inquiries from persons other than their customers.” It would seem that requiring a filing to perfect a security interest in deposit accounts would eliminate the problem of this “secret lien,” and such a requirement has been suggested by at least one commentator. See Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 Emory Bankr. Dev. J. 421, 464-67 (2005). The justification for giving the depository bank automatic perfection by control is given in Official Comment 3 to UCC § 9-104: “No other form of public notice is necessary; all actual and potential creditors of the debtor are always on notice that the bank with which the debtor’s deposit account is maintained may assert a claim against the deposit account.” Whether all actual and potential creditors of the debtor are actually aware of this potential secret lien seems questionable.

Official Comment 4 to UCC § 9-327 suggests that a secured party can protect itself as to proceeds by doing the following:

A secured party who claims the deposit account as proceeds of other collateral can reduce the risk of becoming junior by obtaining the debtor’s agreement to deposit proceeds into a specific cash-collateral account and obtaining the agreement of that bank to subordinate all its claims to those of the secured party.

Of course, this requires the agreement and the cooperation of the debtor and the bank. Official Comment 4 goes on to concede that “if the debtor violates its agreement and deposits funds into a deposit account other than the cash-collateral account, the secured party risks being subordinated.” Id.

VI. Depository Bank’s Right of Setoff Against Commercial Deposit Account

Setoff is the right of a party to reduce the amount another owes it by the amount that party owes the other arising from an unrelated transaction. A deposit account represents a debt the depository bank owes to its depositor in the amount of the account balance. If the depositor defaults on an obligation owed to the depository bank (often a loan), setoff entitles the bank to debit the account in the amount of the outstanding obligation owed to it by the depositor. Article 9 does not create these setoff rights, but UCC § 9-340 does recognize the bank’s setoff rights created under non-Article 9 law.

UCC § 9-109(d)(10)(A) provides that Article 9 generally does not apply to setoff rights, but then states that UCC § 9-340 does apply with respect to the effectiveness of rights of setoff against deposit accounts. UCC § 9-340(a) states the general rule that a depository bank’s setoff

rights have priority over a conflicting security interest in the deposit account. UCC § 9-340(c) then sets out an exception: the bank's setoff rights are "ineffective" when the secured party has control over the deposit account by becoming the account holder of record. Generally, the bank-customer relationship is entirely consensual, and a depositary bank can refuse to enter into unwanted customer relationships. Since the depositary bank may refuse to allow a secured party to become its customer, the bank has control over the subordination of its setoff rights. Similarly, the depositary bank can refuse to enter into any subordination agreement sought by the secured party. See UCC § 9-339. Thus, the bank's setoff rights will generally have priority over the rights of a secured party. UCC § 9-340 clearly governs a depositary bank's setoff rights in a commercial deposit account, whether the secured party is claiming an interest in the deposit account as original collateral or as proceeds of other Article 9 collateral. It's applicability to consumer deposit accounts is less clear.

VII. Depositary Bank's Right of Setoff Against Consumer Deposit Account

It would seem that Article 9's setoff rules would not apply when the secured party is claiming the consumer deposit account as original collateral. As discussed earlier, UCC § 9-109(d)(13) provides that Article 9 does not apply to "an assignment of a deposit account in a consumer transaction, but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds." Because Article 9 clearly does not apply to consumer deposit accounts as original collateral (with the exceptions stated), it would appear that the depositary bank's setoff rights in these deposit accounts would not be governed by UCC § 9-340. Therefore, pre-1998 revision cases need to be considered.

Former UCC § 9-104(i) provided that "Article [9] does not apply to . . . any right of setoff." Under former Article 9 courts, applying different theories, generally found that a security interest took priority over the bank's right of setoff. Some courts applied the basic UCC priority rule set out in UCC § 9-201 that "[e]xcept as otherwise provided [in the Uniform Commercial Code], a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors." Since Article 9 did not provide otherwise, the secured creditor would have priority over the bank's right to setoff. See, e.g., Se. Fin. Corp. v. Nat'l Bank, 377 N.W.2d 900 (Mich. Ct. App. 1985) (creditor with perfected security interest in inventory and proceeds prevails over bank's right of setoff); Assocs. Discount Corp. v. Fid. Union Trust Co., 268 A.2d 330 (N.J. Super. Ct. Law Div. 1970) (creditor with security interest in proceeds of accounts receivable has priority over bank's right of setoff).

Other courts found Article 9 completely inapplicable and applied common law rules. In discussing the common law approach taken by the courts, Professor Walt explains:

The majority of courts adopt the “legal” rule. According to this rule, the bank cannot apply deposited funds in which a third party has an interest to satisfy the debtor’s obligation to it if the bank knows or has notice of the third party’s interest. A significant minority of courts adopt the “equitable” rule. The equitable rule prevents the bank from applying the funds in the same circumstances, even if the bank lacks knowledge or notice, unless the bank relies on the depositor’s apparent ownership of the account or has “superior equities.”

See Steven Walt, *After Article 9: Security Interests and Bank Setoffs in Consumer Deposit Accounts*, 125 Banking L.J. 224, 230-31 (2008) (citations omitted).

Since a party taking a security interest in a consumer deposit account must have exclusive control over that account, whichever rule is applied, the bank will almost certainly have knowledge or notice of the security interest. Therefore, a depository bank would very rarely be able to setoff against consumer deposit accounts serving as original collateral.

Professor Walt recognizes that a depository bank might be unaware of a security interest in a deposit account where the secured party is claiming the account as proceeds of other Article 9 collateral, but he concludes that “Article 9, including its setoff rules, applies to all deposit accounts (commercial and consumer) when they are proceeds of collateral.” *Id.* at 231. This seems correct, as there has been no “assignment of a deposit account in a consumer transaction” when the secured party is claiming the account as proceeds of other Article 9 collateral. Therefore, it is appropriate to apply Article 9.

VIII. Transferees of Funds from Encumbered Deposit Accounts

While a security interest generally continues in proceeds that are transferred to a third party, Official Comment 2(c) to former UCC § 9-306 provided:

Where cash proceeds are covered into the debtor’s checking account and paid out in the operation of the debtor’s business, recipients of the funds of course take free of any claim which the secured party may have in them as proceeds. What has been said relates to payments and transfers in the ordinary course. The law of fraudulent conveyances would no doubt in appropriate cases support recovery of proceeds by a secured party from a transferee out of ordinary course or otherwise in collusion with the debtor to defraud the secured party.

In Harley-Davidson Motor Co. v. Bank of New England, 897 F.2d 611, 622 (1st Cir. 1990), now Supreme Court Justice Breyer considered the scope of the exception as stated in that Comment:

If, however, courts too readily impose liability upon those who receive funds from the debtor's ordinary bank account—if, for example, they define “ordinary course” of business too narrowly—then ordinary suppliers, sellers of gas, electricity, tables, chairs, etc., might find themselves called upon to return ordinary payments (from a commingled account) to a debtor's secured creditor, say a financier of inventory. Indeed, we can imagine good commercial reasons for not imposing, even upon sophisticated suppliers or secondary lenders, who are aware that inventory financiers often take senior secured interests in “all inventory plus proceeds,” the complicated burden of contacting these financiers to secure permission to take payment from a dealer's ordinary commingled bank account. [citations omitted]. These considerations indicate that “ordinary course” has a fairly broad meaning; and that a court should restrict the use of tracing rules to conduct that, in the commercial context, is clearly improper.

When Article 9 was revised and UCC § 9-332 was adopted, the language regarding “operation of the debtor's business” and “ordinary course” did not make the transfer from Official Comment 2(c), only the language regarding “collusion” did so. The drafters of current Article 9 wanted to provide broad protection to transferees to ensure that security interests in deposit accounts do not impair the free flow of funds. See Official Comment 2 to UCC § 9-332. To this end, UCC § 9-332(b) provides that “[a] transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party.” This section applies whether the secured party is claiming a security interest in the deposit account as original collateral, or a security interest in funds in the account as proceeds of other Article 9 collateral. See Keybank Nat'l Ass'n v. Ruiz Food Prods., Inc., No. Civ 04-296, 2005 WL 3748521 (D. Idaho June 29, 2005) (for purposes of UCC § 9-332(b), there is no distinction between a security interest in the account and a security interest in the funds that the account holds). In either case, the transferee takes free of the security interest. Unfortunately, the UCC does not define the term “transferee,” nor does it make clear how a court should determine when “collusion” exists. A number of courts have addressed these issues.

A. “Transferees” under UCC § 9-332

While the term “transferee” is not defined in the UCC, it is clear that the debtor itself is not a transferee. As Official Comment 2 to UCC § 9-332 explains:

[T]his section does not cover the case in which a debtor withdraws money (currency) from its deposit account or the case in which a bank debits an encumbered account and credits another account it maintains for the debtor.

A transfer of funds from a deposit account, to which subsection (b) applies, normally will be made by check, by funds transfer, or by debiting the debtor's deposit account and crediting another depositor's account.

If a debtor withdraws money (currency) from an encumbered account and transfers that money to a third party, then UCC § 9-332(a) would apply, which provides that “[a] transferee of money takes the money free of a security interest unless the transferee acts in collusion with the debtor in violating the rights of the secured party.” There is no requirement that the transferee under UCC § 9-332 (a) or (b) demonstrate a change of position or reliance on the transfer; the only limitation included in the statute that would prevent a transferee from taking the transfer free from a security interest is the element of collusion.

In Orix Financial Services, Inc. v. Kovacs, 83 Cal. Rptr. 3d 900 (Cal. Ct. App. 2008), the court had to decide whether a judgment creditor is the kind of transferee contemplated by UCC § 9-332(b). In that case, the secured party had a perfected security interest in a deposit account as proceeds of a security interest in other collateral. A judgment creditor garnished the deposit and the depository turned the funds over to the judgment creditor. The secured party sued the judgment creditor to recover these funds claiming unjust enrichment. While conceding that the secured party had priority to the deposit account itself, it was argued that this was immaterial once the depository transferred funds to the judgment creditor. The court agreed, finding that the judgment creditor was a “transferee” under UCC § 9-332(b) even though the transfer was involuntary, and so it took free of the security interest. The court rejected the secured party's argument that UCC § 9-332(b) applies only when there is some volitional act by the debtor, finding that only a “transfer” is required for this provision to be applicable, and a transfer indisputably occurred in that case.

The bankruptcy court in In re Mitkem Technologies, No. 09-10979, 2009 WL 2843287 (Bankr. D. Mass. Aug. 31, 2009), considered whether a bankruptcy trustee might be a transferee under UCC § 9-332(b). In that case, the secured party, Bank of America, had a perfected interest in two deposit accounts (one at Bank of America and another at Sovereign bank) as proceeds of a security interest in debtor's accounts receivable. When the debtor filed for Chapter 7 relief, the trustee closed both deposit accounts and deposited the funds into a trustee account. The secured party moved for relief from the automatic stay with respect to the bank account funds now in the trustee's possession. The trustee argued that the secured party failed to satisfy its evidentiary burden that the accounts' funds were identifiable

proceeds, and that even if it had satisfied this burden, the trustee took free of the security interest because it was a transferee under UCC § 9-332(b). The bankruptcy court granted the secured party's motions, finding that the accounts' funds were identifiable proceeds, and that the trustee was not transferee under UCC § 9-332(b). The court stated that "[t]he trustee ... is not a transferee under § 9-332(b), and to the extent that other courts have decided differently, I respectfully disagree." 2009 WL 2843287, at *2.

On the other hand, the bankruptcy court in Limor v. First National Bank of Woodbury (In re Cumberland Molded Prods., LLC), No. 308-07812, 2009 WL 2208582 (Bankr. M.D. Tenn. July 22, 2009) found that a trustee could be entitled to the protection afforded to a transferee of funds from a deposit account. In that case, the bank had a perfected security interest in various types of debtor's collateral, including accounts receivable. Funds collected by the debtor from its customers in payment of these accounts receivable were deposited into a checking account that debtor had with the bank. The debtor filed a voluntary Chapter 7 petition on September 3, 2008, and that same day drew a check on the deposit account in the amount of \$454,655 payable to the Chapter 7 trustee, which was posted to the trustee's account on September 12. On October 8, at the request of the trustee, the debtor turned over to the trustee the remaining funds in the deposit account (\$1812) by delivering a cashier's check to the trustee, which was posted to the trustee's account on October 20. The checking account was subsequently closed by the debtor. While the bank knew that the debtor had filed for bankruptcy by September 5, it chose not to exercise its right to freeze the checking account for purposes of set-off, and instead filed a motion for relief on November 14, after all funds in the checking account had been withdrawn and the account had been closed.

The bank, relying on UCC § 9-315, argued that it had a perfected security interest in the identifiable cash proceeds of the accounts receivable that were paid to the trustee. The court found Official Comment 7 to UCC § 9-315 "enlightening on the limitations of [the bank's] argument." 2009 WL 2208582, at *2. That comment states that, in many cases, a purchaser or other transferee of cash proceeds will take free of the perfected security interest, and specifically refers to Section 9-332's transferee of money or funds from a deposit account. The court noted that, under UCC § 9-332(b), only transferees who act in collusion with the debtor are excepted from the protections afforded by that provision, and found that no such collusion was alleged here. The court concluded, therefore, that "the Chapter 7 Trustee is entitled to the broad protections of a transferee of funds from a deposit account." 2009 WL 2208582, at *2.

B. "Collusion" under UCC § 9-332

Former UCC § 9-306 contained the basic rule that a secured party's security interest continued in proceeds of the original collateral, but Official Comment 2(c) to that section noted

that this general rule only applied to a transferee of cash proceeds if the transferee took the proceeds outside of the ordinary course of business. Current UCC § 9-332 is significantly more deferential to transferees of cash proceeds because it requires the secured party to show that the transferee acted “in collusion” with the debtor in receiving the funds rather than merely taking them out of the ordinary course.

Official Comment 4 to UCC § 9-332 states that the “collusion” standard is the most protective (ie., least stringent) of the various standards found in the UCC. Article 9 does not define the term “collusion,” but borrows the term from Article 8, where it is found in several sections. See, e.g., UCC §§ 8-115, 8-503(e). Official Comment 5 to UCC § 8-115 provides that “[t]he collusion test is intended to adopt a standard akin to the tort rules that determine whether a person is liable as an aider or abettor for the tortious conduct of a third party. See Restatement (Second) of Torts § 876.” The Restatement (Second) of Torts § 876 provides for liability for a person acting in concert “if he (a) does a tortious act in concert with the other or pursuant to a common design with him, or (b) knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, or (c) gives substantial assistance to the other in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person.” Official Comment 3 to UCC §8-503 suggests that the collusion standard would require the secured party to show that the transferee “was affirmatively engaged in wrongful conduct, rather than casting on the transferee any burden of showing that the transferee had no awareness of wrongful conduct” by the transferor. As one court has noted, UCC § 9-332 “mandates that provided that the transferee of the cash proceeds is not truly a ‘bad actor’ and colludes with the debtor, the transferee will take the cash proceeds free of the senior secured creditor’s interest.” See Gen. Elec. Capital Corp. v. Union Planters Bank, N.A., & Machinery, Inc. (In re Machinery, Inc.), 342 B.R. 790, 801 (Bankr. E.D. Mo. 2006).

One commentator has raised the following question:

What if a debtor does not wish to come to the secured creditor with hat in hand, seeking to liberate cash to pay its professionals? Suppose further that the security agreement covers deposit accounts and has an explicit provision (perhaps tied to financial condition) that prohibits the debtor from using its cash to do anything other than pay trade creditors in the ordinary course of business without secured creditor permission. Might the bankruptcy attorney or other turnaround professional be liable for accepting fees if those funds are paid out of a deposit account that is subject to such a prior, perfected security interest? An affirmative answer to that question could give the secured creditor a trump card in a workout negotiation.

See Lawrence R. Ahern, III “Workouts” Under Revised Article 9: A Review of Changes and Proposals for Study, 9 Am. Bankr. Inst. L. Rev. 115, 165 (2001).

IX. Bankruptcy and Security Interests in Deposit Accounts

Some commentators have expressed concerns over the treatment of deposit accounts in current Article 9. For example, Professor Lipson is concerned about the “secret liens” that will arise by virtue of the new rules concerning the creation of “control” security interests in bank accounts. See Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 Emory Bankr. Dev. J. 421, 462-66 (2005).

Professor Warner has expressed numerous concerns about current Article 9’s treatment of deposit accounts and the effect it may have in bankruptcy. He worries that the inclusion of deposit accounts as original collateral within the scope of Article 9 may materially reduce the amount of free assets available in bankruptcy. See G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 Am.. Bankr. Inst. L. Rev. 3, 47 (2001) (“By providing clear and simple rules for taking and perfecting deposit account security interests, [current Article 9] will likely result in lenders routinely obtaining security interests in debtor’s bank accounts. . . . Obviously, this will result in a reduction of the amount of free assets available in bankruptcy and will shift the allocation of the debtor’s insolvency shares accordingly.”).

Professor Warner sees other problems with permitting creditors to take security interests in deposit accounts as original collateral. Because deposit accounts may now be subject to liens even when the funds in the accounts are not proceeds of some other collateral, he is concerned that this may make it difficult for a debtor to provide adequate protection, which is required as a pre-condition to the use of cash collateral under Bankruptcy Code § 363. He points out that:

[I]f the cash collateral is the proceeds of some other item of the same creditor’s collateral, it may be possible to provide adequate protection by agreeing to use the cash collateral to enhance or maintain the value of the non-cash collateral. For example, rents can be used to operate and maintain the real estate collateral, or the cash proceeds of inventory can be used to purchase new inventory. However, if the first priority lien on the deposit account is held by a creditor who does not have other collateral [a creditor with a security interest in the deposit account as original collateral], the debtor may not be able to use the funds in the account to operate the business unless it can provide some other form of adequate protection.

Id. at 76.

Professor Warner notes that this problem is exacerbated by the priority rules in current Article 9. He explains that, under current Article 9:

[T]he depositary bank's rights of setoff and recoupment generally will have priority over the proceeds security interest. Further, if a competing creditor has obtained a security interest in the bank account as original collateral and has perfected by control, its security interest also will be superior to the proceeds security interest. Finally, even if the proceeds creditor foresees the problem and obtains and perfects an Article 9 security interest in the account as original collateral, its perfected security interest generally will be subordinate to an Article 9 security interest held by the depositary bank.

Id. at 77.

An alternative to providing adequate protection is to obtain the consent of the secured party. See Bankruptcy Code § 363(c)(2)(A). Professor Warner is concerned that in cases when the debtor must use cash collateral in order to continue its business operations, "this greatly increases the secured creditor's leverage by giving it effective veto power over the reorganization effort." Warner, 9 Am. Bankr. Inst. L. Rev. at 77. But see Steven L. Harris and Charles W. Mooney, Jr. *Revised Article 9 Meets the Bankruptcy Code: Policy and Impact*, 9 Amer. Bankr. Law Inst. L. Rev. 85, 102-104 (2001) (suggesting that Professor Warner has exaggerated the likely impact on bankruptcy of permitting the use of deposit accounts as original collateral).