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SECURED LENDING ALERT

Perfecting a Security Interest in a Securities Account

This article explores perfection of a lender's security interest in uncertificated securities and other financial assets held in a brokerage account (hereafter, referred to as a "securities account"). This type of collateral is increasingly becoming part of the collateral for commercial loans; therefore, an examination of this topic is timely for many loan officers and other bank and finance company personnel.

In 1996 (prior to the adoption of Revised Article 9 which took effect in 2001), the Illinois Uniform Commercial Code was amended to provide for perfection of a security interest in "investment property" by control. "Investment property" includes certificated and uncertificated securities, security entitlements, securities accounts, commodity contracts and commodity accounts.

Thus, Illinois was one of the few early states that adopted the "control" method for perfecting a security interest in a securities account and other investment property. Revised Article 9 continued to provide that control over investment property is the preferred method of perfection of a security interest in investment property.

Generally, a lender perfecting a security interest in a securities account by "control" must:

(a) enter into a written security agreement executed by the owner of the securities account being pledged; and

(b) obtain a written three-party control agreement signed by the owner of the securities account, the securities intermediary (which is typically the brokerage house or bank where the uncertificated securities and other financial assets are held) and the lender, containing adequate "control" language (described below). An alternative method of "control" is titling the securities account in the lender's name. This alternative method of "control" is described below.

The control agreement itself usually does not grant the security interest in the securities account. As indicated above, a separate security agreement executed by the registered owner of the securities account in favor of the secured lender is entered into. The securities intermediary will not typically want to become involved with that portion of the transaction.

Under Code Sections 9-106 and 8-106, with respect to a securities account, "control" is achieved by the secured lender when either (i) with the consent of the account owner, a securities intermediary has agreed (in the control agreement) that it will comply with entitlement orders (instructions to transfer or redeem securities or other financial assets in the securities account) from the secured lender without further consent from the account owner, or (ii) the securities account is titled in the secured lender's name.

Many lenders obtain control by complying with subsection (i) of the preceding paragraph which requires a careful review and negotiation of the three-party control agreement described above. Other lenders sometimes opt for the control method described in subsection (ii) above and title the securities account in the secured party's name. However, titling a securities account in the secured lender's own name can be a more complicated method of obtaining control (and could cause possible tax and trading issues for the secured lender), and many lenders prefer to employ the three-party control agreement to gain control over the securities account. Also, a number of lenders that title the securities account in such lender's name (and thus have achieved "control") still insist upon obtaining a control agreement signed by the beneficial owner/pledgor and the securities intermediary to obtain the benefit of the numerous "pro-lender" provisions contained in the control agreement.

What a control agreement should contain at a minimum. It should be noted at the outset that most established brokerage houses (or other securities intermediaries such as banks) have established their own standard form of control agreement for lenders to use and typically do not accept a lender's own form. This practice requires a lender to pre-review the securities intermediary's standard control agreement form prior to the proposed loan transaction and attempt to negotiate any desired changes. A broker or other securities intermediary is not required by law to enter into a control agreement and if a secured lender is unable to negotiate an acceptable form of control agreement with a securities intermediary, the parties should consider transferring the assets in the securities account to another securities intermediary that employs a control agreement form acceptable to the lender.

It is beneficial to compile a list of provisions a secured lender would like to have in the control agreement for a securities account. The following list is not meant to be exhaustive, but a brief summary of some standard or desirable provisions for a control agreement:

1. As indicated, an essential provision for perfection is that the control agreement contain a provision vesting "control" of the securities account in the lender obtaining a security interest in the securities account.

Code Section 8-106 (d)(2) provides that a purchaser (which term includes a lender) has "control" of a security entitlement if: "the securities intermediary has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder; …"

The Article 8 terminology is different than what most lenders are accustomed to, but a quick summary of the important defined terms is needed to examine perfection of a security interest in a securities account:

(1) the term "entitlement order" is a notice to the securities intermediary directing it to transfer or redeem a financial asset to which the owner has a security entitlement (i.e., a direction to the broker or other securities intermediary to sell or transfer an uncertificated security or other asset in the securities account),

(2) the term "security entitlement" means the rights and property interest of an entitlement holder with respect to financial assets held in a securities account,

(3) the term "entitlement holder" means "a person identified in the records of a securities intermediary as the person having the security entitlement against the securities intermediary (typically the registered owner of the account), and

(4) the term "financial assets" is very broad and includes (i) securities, (ii) obligations of or interests in a person or property or an enterprise that is of a type traded on financial markets or recognized as a medium for investment, and (iii) property held by broker in the securities account if broker agrees that the property is to be treated as a financial asset under Code Section 8-102(a)(9). This term basically includes both securities and all other interests held in the securities account.

Several sample control provisions (taken from sample control agreements used by some national brokerage firms or banks) read as follows:

"The Securities Intermediary will comply with all entitlement orders originated by the Lender without further action or consent by Account Holder or any other person."

"Broker will comply with all notifications it receives directing it to transfer or redeem any property in the Account (each an "Entitlement Order") originated by Lender without further consent by Customer."

"In regard to the Account, from and after the date of this Agreement, the Broker shall act only upon the Lender's sole written instructions or entitlement orders, without further consent of the Customer."

An important observation to note is that although it is in the secured lender's best interest that in crafting the "control" provision in a control agreement, the security

intermediary's obligation to act on the secured lender's instructions be unconditional, the Code does not require such obligation to be unconditional. Official Comment 7 to Code Section 8-106 recognizes that the security intermediary's obligations to act on the secured lender's instructions need not be unconditional so long as further consent of the account owner is not required. For example, Official Comment 7 itemizes the following factual situations that will not be deemed to cause a secured lender to lose its "control" over a securities account (none of which require the further consent of the account owner): (i) permitting the debtor (account owner) to trade in the account, (ii) permitting both a senior lender and a junior lender to both have control over the account, wherein the junior lender's instructions to the securities intermediary require the senior lender's consent, and (iii) the security intermediary agrees to act on the secured lender's instructions provided the secured lender has delivered a statement to the securities intermediary that the account owner is in default. Notwithstanding these Code provisions, the best scenario for the secured lender is that the control agreement provide that the security intermediary's obligation to act on the secured lender's instructions is unconditional (although this is not always possible under the factual circumstances of each transaction). The reason for this is that the securities intermediary should not become involved in a dispute over whether an event of default has occurred or whether any other required condition has been met. Official Comment 7 even recommends that any conditions upon the secured lender's exercise of its rights under the control agreement be contained in the security agreement between the account owner and the secured lender, and not be set forth in the control agreement, to avoid placing the securities intermediary in the middle of a dispute between the account owner and secured lender as to whether the required condition has been met.

2. As indicated above, assuming the requisite control language described above is set forth in a control agreement, a secured lender can continuously be deemed "in control" of a securities account throughout the term of the control agreement, even though the secured lender permits the account owner or an investment advisor to trade in the account. Many control agreements provide that although the secured lender always shall be deemed in control of the securities account, until the securities intermediary receives a written notice that the secured lender is taking "exclusive control" over the securities account, that the account owner or a designated investment advisor may make trades in the account so long as no property (including sale proceeds) is withdrawn from the securities account at any time (although some control agreements do permit a securities intermediary to distribute to the account owner all interest and regular cash dividends during the term of the control agreement). Under this format where trading is permitted in the account, the secured lender will sometimes provide in its security agreement with the pledgor that the secured party reserves the unqualified right to take exclusive control of the securities account upon the occurrence of an event of default under the security agreement.

A number of control agreements further provide that the securities intermediary shall not be liable to the secured lender unless the securities intermediary complies with entitlement orders originated by the account owner (a) at any time, if the account owner has no trading authority in the account pursuant to the control agreement, or (b) if the

account owner is allowed to trade in the account pursuant to the control agreement, after the securities intermediary receives a notice of exclusive control from the secured lender and has had a reasonable opportunity to act on such notice of exclusive control.

Most control agreements also require the account owner to indemnify the securities intermediary from any claims, losses, liabilities and expenses (collectively hereafter, "Losses") arising from any claim of any party resulting from actions the securities intermediary takes in accordance with the control agreement. It should be noted that quite a number of control agreements also require the secured lender to enter into the broad indemnity described in the preceding sentence jointly and severally with the account owner. However, such indemnity typically excludes Losses incurred by the securities intermediary caused by the security intermediary's gross negligence or willful misconduct. A carve-out from such indemnity should be crafted since the securities intermediary should remain liable to the lender for complying with entitlement orders from the account owner at a time when the lender has exclusive control over the account or for permitting any withdrawals from the account not consented to by the lender or for permitting another control agreement to be lodged without the consent of the lender.

3. An absolutely essential provision for a control agreement is one whereby the securities intermediary subordinates any security interest or lien it may claim in the securities account to the lender's security interest therein. This is strongly recommended because in the absence of such subordination by the securities intermediary in the control agreement, a securities intermediary's lien in the securities account will have priority over the secured lender's security interest therein. This special priority rule is found in Code Section 9-328(3) which reads "A security interest held by a securities intermediary in a security entitlement or a securities account maintained with the securities intermediary has priority over a conflicting security interest held by another secured party."

All well-drafted control agreements contain such a subordination, however, the burden is on the lender to make sure that the control agreement (which, as indicated above, is typically generated by the securities intermediary) contains a subordination provision and that it is adequate. There are standard carve-outs where the securities intermediary preserves its priority in property in the securities account (i) to secure payment for property purchased in the securities account, and (ii) for normal commissions and fees payable to the securities intermediary for the securities account.

A sample subordination provision reads as follows: "Broker subordinates in favor of Lender any security interest, lien or right of setoff it may have, now or in the future, against the Account or property in the Account, except that Broker will retain its prior lien on property in the Account to secure payment for property purchased for the Account and normal commissions and fees for the Account."

4. A related issue that needs to be documented in the control agreement is that the securities intermediary should confirm that the securities account is not a margin

account and that no margin or other credit will be extended to the account owner in the securities account.

5. It is a good idea to have the securities intermediary represent and warrant to the secured lender that (a) the specific securities account has been established with the securities intermediary, (b) the account owner/pledgor is the registered owner of the account, and (c) that attached as Exhibit A to the control agreement is the most recent monthly statement for the securities account produced by the securities intermediary in the ordinary course of its business regarding the property credited to such account as of the date of the statement and that the securities intermediary does not know of any inaccuracy in the statement.

6. Another common provision in control agreements is that the securities intermediary will acknowledge that the owner of the securities account has granted the lender a security interest in such account and that the parties are entering into the control agreement to perfect the lender's security interest in such account.

7. It is preferred that the securities intermediary acknowledge in the control agreement that it does not know of any claims to or interest in the securities account, except for those of the parties to the control agreement, and further that the control agreement contains the securities intermediary's agreement that it will not enter into any other control agreement with regard to the subject securities account while the control agreement remains in effect. It is also helpful to require the securities intermediary to represent that no third party has a right to give an entitlement order regarding financial assets in the securities account.

8. A control agreement typically requires the securities intermediary to send copies of all statements and confirmations for the securities account simultaneously to the account owner and the secured lender.

9. Another beneficial provision is to require the securities intermediary to use reasonable efforts to promptly notify the secured lender and the account owner if any other person claims that it has a property interest in the securities account or any property contained therein.

10. Another sample provision for control agreements is as follows: "All property credited to the Account, and all other rights of Customer against Broker arising out of the Account, including any free credit balances, will be treated as financial assets under Article 8 of the [Illinois] Uniform Commercial Code." This provision assures that the secured creditor will have a perfected security interest in all property in the securities account, even if the property is not a security.

11. The control agreement should provide that the duties of the securities intermediary shall continue in effect until the security interest has been terminated and the secured creditor has notified the securities intermediary of the termination in writing.

12. Another very important provision in control agreements are those that pertain to the ability to terminate the control agreement. Many control agreements provide for the ability of the securities intermediary or secured lender to terminate the control agreement upon prior notice (for example, 30 days prior notice). However, most of the control agreements sampled fail to provide what happens to the property in the securities account after termination. A desirable provision to insert is one that provides that upon any termination of the control agreement by the securities intermediary, the securities intermediary and account owner agree that if the secured lender's debt shall not have been fully paid, that the property in the securities account will be transferred to another securities account under the exclusive control of the secured lender as collateral security for the outstanding indebtedness secured by the security agreement. The account owner should not have the ability to terminate the control agreement.

Miscellaneous Comments:

1. Secured lenders will want to examine the most current brokerage statement for the securities account to be pledged to confirm the name(s) of the account owner, evaluate the soundness and ownership of the investments in the account, and make sure the account is not an IRA, 401K or other form of retirement account. Also, sometimes certain assets listed on a brokerage statement are not considered to be in the securities account and cannot be perfected by a control agreement (these would include financial assets registered in the customer's name, payable to the customer's order or specially endorsed to the customer, which have not been endorsed to the securities intermediary or in blank). Some securities intermediaries mark these types of financial assets as "certificated" or "in safekeeping". When dealing with such restricted assets, several approaches include (i) having the securities intermediary itemize the restricted assets that will not be considered part of the account or (ii) moving such restricted financial assets to a separate account that is not encumbered.

2. Some lenders insert in the security agreement between the account owner and the lender a provision that if the current market value of the securities accounts falls below a stated dollar figure (the "Minimum Collateral Value"), that the pledgor has a certain number of days to deposit additional monies or securities in the account so that the Minimum Collateral Value is maintained, and that failure to comply with this provision constitutes an event of default under the security agreement.

3. Although a secured lender can also perfect its security interest in a securities account by filing a UCC financing statement, the highest form of priority is for a secured lender to take "control" of the securities account under Code Section 8-106 (described above in this article). Under Code Section 9-328(1), a security interest in a securities account held by a secured party having control of such account has priority over a security interest held by a secured party that does not have control of such account (i.e., by filing a UCC). Secured lenders should rarely rely on a UCC statement for perfection of a security interest in a securities account. Only one circumstance comes to mind in which a secured lender would perfect a security interest in a securities account by filing a UCC statement, and that is when another lender already has control of the securities

account, and such lender will not allow the secured lender to lodge a subordinate control agreement with the securities intermediary, leaving the secured lender with the only option of relying on a UCC statement to perfect its junior security interest. The risks of perfection solely by filing a UCC statement are many, including (i) the inability to block control agreements from being lodged with the broker or other securities intermediary from time to time, each of which would prime the security interest perfected by the UCC filing under Code Section 9-328(1), and (ii) lack of priority over outright purchasers of the securities collateral. The primary benefit of a UCC filing is that it will protect the secured lender against the pledgor's trustee in bankruptcy, but the risks far outweigh such benefit and it would be a very rare situation where a lender would rely solely on a UCC filing for perfection in a securities account.

For those lenders who still feel the urge to file a UCC filing, in addition to taking "control" of the account under one of the methods described below, perhaps the following strong language in Official Comment 3 to Code Section 9-328 will give you the comfort to skip the precautionary UCC filing: "Although filing is now a permissible method of perfection, in order to avoid disruption of existing practices in this business it is necessary to give perfection by filing a different and more limited effect for securities than for some other forms of collateral. The priority rules are not based on the assumption that parties who perfect by the usual method of obtaining control will search the files. Quite the contrary, the control priority rule is intended to ensure that, with respect to investment property, secured parties who do obtain control are entirely unaffected by filings. To state the point another way, perfection by filing is intended to affect only general creditors or other secured creditors who rely on filing."

This article is informational in nature and is not intended to constitute, nor should it be relied upon as, legal advice to any recipient.

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Bennett L. Cohen is a partner in the law firm of Cohen, Salk & Huvard, P.C. Bennett concentrates his practice in secured lending. He regularly represents banks, commercial finance companies, insurance companies and other institutional lenders in the structuring, documentation and closing of secured lending transactions, including asset-based loans, commercial loans, commercial real estate mortgage and construction loans, mezzanine loans, leveraged acquisitions, equipment lease loans and factoring transactions. He served for fifteen years as general counsel to the Midwest Association of Secured Lenders, a trade association of over eighty banks and finance companies located in Chicago and outlying areas. Bennett is a member of the American Bar Association and serves on the ABA Committee on Commercial Financial Services and the ABA Subcommittees on Secured Lending, Loan Documentation and the Uniform Commercial Code. He is a member of the ABA Joint Task Force on Deposit Account Control Agreements, the ABA Model Intercreditor Task Force, and the ABA Joint Task Force on Filing Operations and Search Logic.