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# Perfecting Security Interests in Deposit Accounts, Securities Accounts and Other Investment Property

Establishing Control Under the UCC to Perfect Security Interests in Special Collateral Types

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Today's faculty features:

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***Perfecting Security Interests in Deposit Accounts, Securities Accounts and Other Investment Property: Establishing Control Under the UCC to Perfect Security Interests in Special Collateral Types***

*Lynn A. Soukup  
Steven O. Weise*

October 26, 2011

**INDEX TO MATERIALS**

1. PowerPoint Presentation
2. Control of Collateral: UCC Framework
3. Deposit Accounts and Securities Accounts as Collateral: Twin Sons of Different Mothers
4. A Model “Account Control Agreement” under Revised Article 9 of the UCC
5. Control Agreement Regarding Uncertificated Securities
6. Equity Interests as Collateral

**Control of Collateral:  
UCC Framework**

**Lynn A. Soukup  
Steven O. Weise**

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# **Control of Collateral: UCC Framework**

## **TABLE OF CONTENTS**

1. Collateral in Which a Security Interest May (or Must) be Perfected by Control.....	1
2. Control of a Deposit Account .....	5
3. Control of a Certificated Security .....	7
4. Control of an Uncertificated Security .....	8
5. Control of a Securities Account or Security Entitlement.....	9
6. Control of a Commodity Contract or Commodity Account.....	11
7. Control of a Letter-of-Credit Right.....	11
8. Control of Electronic Chattel Paper or an Electronic Document.....	11
9. Priority of Security Interests .....	12
10. Protected Purchaser Status and “Takes Free” Rules.....	16
11. Choice of Law.....	17
12. Collateral Description and Collateral Indication .....	19
13. Additional Considerations .....	20
14. Rights and Duties of Secured Party Having Control of Collateral .....	22
15. Enforcement of Secured Party Remedies.....	23
16. Legal Opinions.....	24
17. Control Agreements.....	25

### **Exhibit A – General Information Regarding the UCC Official Text and Comments**

## Control of Collateral: UCC Framework

### 1. Collateral in Which a Security Interest May (or Must) be Perfected by Control

- (a) UCC<sup>1</sup> § 9-314(a) provides that a security interest in the following types of collateral may be perfected by control:
  - (i) deposit accounts;<sup>2</sup>
  - (ii) investment property:<sup>3</sup>
    - (A) certificated securities,<sup>4</sup>
    - (B) uncertificated securities,<sup>5</sup>

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<sup>1</sup> See **Exhibit A** for general information regarding the Official Text of and Official Comments to the UCC.

<sup>2</sup> “**Deposit account**” is defined in UCC § 9-102(a)(29) and “**bank**” is defined in UCC § 9-102(a)(8). An account evidenced by an instrument is excluded from the definition of deposit account.

UCC § 9-109(d)(13) provides that UCC Article 9 does not apply to an assignment of a deposit account in a consumer transaction (except that UCC §§ 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds). Accordingly, the creation and (subject to the exception for proceeds) perfection and priority of a collateral assignment of a deposit account in a consumer transaction will be determined under other (non-UCC) law. See also Official Comment 16 to UCC § 9-109.

UCC § 9-102(a)(26) defines a “**consumer transaction**” 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.” See also Official Comment 7 to UCC § 9-102 and Official Comment 5 to UCC § 9-312 (discussing common law dominion and control concept applicable to security interest in a deposit account not subject to UCC Article 9). Note that the size of the transaction is not relevant to whether it is a consumer transaction for purposes of UCC Article 9.

<sup>3</sup> “**Investment property**” is defined in UCC § 9-102(a)(49).

<sup>4</sup> “**Certificated security**” is defined in UCC § 8-102(a)(4); UCC § 8-103 provides additional rules for determining whether specific types of interests are securities for purposes of the UCC (*e.g.* generally partnership and LLC interest are not securities, even if certificated). The governing documents of the entity or other documents governing the terms of the security, the terms stated on the certificate and applicable law other than the UCC (*e.g.* state entity statutes) will determine whether a security is represented by a certificate.

The definition of both certificated security and uncertificated security is based on the underlying definition of security in UCC § 8-102(a)(15). The 2010 amendments to the UCC add a comment to clarify the definition of security and reject the holding in the *Highland Capital* case. See Revised Official Comment 13 to UCC § 8-102; see also E. Smith, *A Summary of the 2010 Amendments to Article 9 of the Uniform Commercial Code*, 42 UCC L.J. (2010) (hereinafter “**Summary of the 2010 Amendments**”).

With respect to partnership and LLC interests, it is possible to have the issuer agree that the interests are UCC Article 8 securities (and also to have them represented by a certificate), in which case they will be securities (and, if issued in certificated form, certificated securities) to which the analysis in this outline will apply. A more detailed discussion of “opting in” to UCC Article 8 and related matters is included in the article “Equity Interests as Collateral” that accompanies this outline.

- (C) security entitlements and securities accounts,<sup>6</sup> and
- (D) commodity contracts and commodity accounts;<sup>7</sup>
- (iii) letter-of-credit rights;<sup>8</sup>
- (iv) electronic chattel paper;<sup>9</sup> and
- (v) electronic documents.<sup>10</sup>
- (b) Control.
  - (i) The applicable methods of obtaining control of collateral will depend on the type of collateral. *See* UCC §§ 7-106, 8-106, 9-104, 9-105, 9-106 and 9-107.

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<sup>5</sup> “**Uncertificated security**” is defined in UCC § 8-102(a)(18); UCC § 8-103 provides additional rules for determining whether specific types of interests are securities for purposes of the UCC. The terms of the governing documents of the entity or other documents governing the terms of the security, the terms stated on any certificate that has been issued and applicable law other than the UCC (*e.g.* state entity statutes) will determine whether a security is not represented by a certificate (*i.e.* is uncertificated). The most common form of uncertificated security is an interest in a mutual fund.

Uncertificated securities are held directly on the records of the issuer. This distinguishes them from security entitlements, where there are one or more intermediaries (such as DTC, another clearing corporation or a Federal Reserve Bank) between the issuer and the owner, and only the “top-tier” intermediary is shown as the record owner of the security on the books of the issuer (and is the holder of a certificated or uncertificated security).

<sup>6</sup> “**Security entitlement**” is defined in UCC § 8-102(a)(18) and “**securities account**” is defined in UCC § 8-501.

UCC § 8-501(d) provides that if a securities intermediary holds a financial asset for another person, and the financial asset is registered in the name of, payable to the order of, or specially indorsed to the other person, and has not been indorsed to the securities intermediary or in blank, the other person is treated as holding the financial asset directly rather than having a security entitlement with respect to the financial asset. A customer that delivers certificates to a broker with blank indorsements or stock powers is not a direct holder, but has a security entitlement. *See* Official Comment 4 to UCC § 8-501.

“**Financial asset**” is defined in UCC § 8-102(a)(9). *See also* Official Comment 9 to UCC § 8-501.

“**Securities intermediary**” is defined in UCC § 8-102(a)(14) as (i) a clearing corporation (such as DTC) or (ii) a person including a bank or broker, that in the ordinary course of its business maintains securities account for others and is acting in that capacity. *See also* Official Comment 14 to UCC § 8-501.

<sup>7</sup> “**Commodity contract**” is defined in UCC § 9-102(a)(15) and “**commodity account**” is defined in UCC § 9-102(a)(14).

<sup>8</sup> “**Letter-of-credit rights**” is defined in UCC § 9-102(a)(51). The term letter-of-credit rights does not include the right of a beneficiary to demand payment or performance (*i.e.* to draw) under a letter of credit. *See* UCC § 9-102(a)(51) and Official Comment 5(e) to UCC § 9-102.

<sup>9</sup> “**Electronic chattel paper**” is defined in UCC § 9-102(a)(31).

<sup>10</sup> “**Document**” is defined in UCC § 9-102(a)(30) and “**electronic document of title**” is defined within the definition of “**document of title**” in UCC § 1-201(a)(16) (there is no comparable definition in Former UCC § 1-201).

- (ii) The methods of obtaining control with respect to each type of collateral for which control is an available method of perfection (listed in Section 1(a) above) is discussed in Sections 2, 3, 4, 5, 6, 7 and 8 below.
  - (iii) The common element among the concepts of control for deposit accounts, certificated and uncertificated securities, security entitlements and securities accounts, commodity contracts and commodity accounts is that the secured party has the legal right to direct the disposition of collateral without further action or consent of the debtor. *See* UCC §§ 8-106, 9-104 and 9-106.
- (c) For certain types of collateral, control is the only method of perfection (with very narrow exceptions).
- (i) UCC § 9-312(b)(1) provides that a security interest in a deposit account **must** be perfected by control.
 

*Exception:* If the funds in the deposit account are identifiable proceeds of other collateral in which a security interest was perfected, then perfection continues in those funds (subject to the requirements of and limitations provided in UCC §§ 9-315 and 9-332(b)) and control is not required to perfect the security interest. *See* UCC §§ 9-312(b), 9-315 and 9-332(b); *see also* Official Comment 5 to UCC § 9-312 and Official Comments 2 through 7 to UCC § 9-315.
  - (ii) UCC § 9-312(b)(2) provides that a security interest in a letter-of-credit right **must** be perfected by control.
 

*Exceptions:*

    - If the letter-of-credit right is identifiable proceeds of other collateral in which a security interest was perfected, then perfection continues in that letter-of-credit right (subject to the requirements of and limitations provided in UCC § 9-315) and control is not required to perfect the security interest. *See* UCC §§ 9-312(b) and 9-315; *see also* Official Comment 6 to UCC § 9-312 and Official Comments 2 through 7 to UCC § 9-315.
    - If the letter-of-credit right is a supporting obligation<sup>11</sup> the security interest in the letter-of-credit right is automatically perfected if the security interest in the related collateral is perfected. *See* UCC §§ 9-312(b) and 9-308(d); *see also* Official Comment 6 to UCC § 9-312 and Official Comment 5 to UCC § 9-308.

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<sup>11</sup> UCC § 9-102(a)(77) defines “**supporting obligation**” as a letter-of-credit right or secondary obligation that supports the payment or performance of an account, chattel paper, a document, a general intangible, an instrument or investment property. Note that a lease or rents thereunder are excluded from UCC Article 9 (*see* UCC § 9-109(d)(11)) and therefore would not constitute an account, chattel paper, a document, a general intangible, an instrument or investment property for this purpose.

- (d) For other types of collateral, control is one method of perfection but other methods are also available:<sup>12</sup>
  - (i) Perfection by Filing<sup>13</sup>
    - (A) Available method of perfection for investment property, electronic chattel paper and electronic documents.
  - (ii) Perfection by Delivery (*i.e.* Possession)<sup>14</sup>
    - (A) Available method of perfection for certificated securities.
  - (iii) Automatic and Temporary Perfection and Continued Perfection in Proceeds<sup>15</sup>
    - (A) Automatic perfection is an available method of perfection for investment property in specified circumstances (*e.g.* if the security interest is created by a broker or securities intermediary or by a commodity intermediary).
    - (B) Automatic perfection with respect to letter-of-credit rights as supporting obligations (as discussed in Section 1(c) above).
    - (C) Temporary perfection periods also apply to investment property.
    - (D) Continued perfection as to proceeds also applies.<sup>16</sup>
- (e) Selecting a method of perfection:
  - (i) Filing may not be effective (*e.g.* deposit account as original collateral).
  - (ii) Filing may not provide the same protections to the secured party as does control (*e.g.* priority, protected purchaser and “takes free” rules and ability to exercise remedies).<sup>17</sup>
  - (iii) Perfection by filing (where applicable) can have benefits, including.
    - (A) May be faster and less costly than putting control arrangements in place, implementing control arrangements may be a “post-closing” item or third parties may not cooperate in the steps needed to obtain control.
    - (B) May protect the secured party if funds/investments leave a securities account.<sup>18</sup>

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<sup>12</sup> See generally PRACTICE UNDER ARTICLE 9 OF THE UCC at 95-98 (2d ed. 2008).

<sup>13</sup> See UCC §§ 9-310 and 9-312.

<sup>14</sup> See UCC § 9-313(a). Note the difference between delivery and control of a certificated security (as described in Section 3 below).

<sup>15</sup> See, *e.g.*, UCC §§ 9-309(9) - (11), 9-312(e) - (g) and 9-315(c) - (d).

<sup>16</sup> A continuing security interest in proceeds of collateral is subject to the requirements of and limitations provided in Article 9, including those provide in UCC § 9-315.

<sup>17</sup> See Sections 9, 10 and 15 below.



- (C) May protect the secured party if the debtor fails or refuses to deliver possession of collateral or enter into other arrangements needed to effect control of after-acquired property.
- (D) May protect the secured party if there is a defect in perfection by control.
- (E) May provide additional protection as to proceeds.
- (iv) Perfection by filing may be sufficient protection given the secured party's reliance on particular collateral (e.g. secured party may be seeking only protection in bankruptcy or from tax and other lien creditors).

## 2. Control of a Deposit Account

- (a) UCC § 9-104(a) provides that a secured party has control of a deposit account if:
  - (i) the secured party<sup>19</sup> is the bank with which the deposit account is maintained;<sup>20</sup>
  - (ii) 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

<sup>18</sup> See H. Darmstadter, *Introduction to Account Control Agreements*, included in the material for **Even if You are a Real Estate/Securities/Corporate/Partnership/Emerging Company/Finance Lawyer: What Every Lawyer Needs to Know about UCC Article 8** presented at the ABA Business Law Section 2003 Spring Meeting.

<sup>19</sup> UCC § 9-102(a)(72) defines “**secured party**” to include (i) a person in whose favor a security interest is created or provided for under a security agreement or (ii) a trustee, indenture trustee, agent, collateral agent or other representative in whose favor a security interest is created or provided for. Official Comment 2(b) to UCC § 9-102 reinforces that the identity of the secured party is determined by the security agreement. For example, in a multi-bank facility under which the banks act as lenders, and one of those banks (or a third party) acts as collateral agent, if the security interest is granted to the banks then they are all secured parties but if the security interest is granted to the collateral agent then the collateral agent is the secured party.

<sup>20</sup> The 2010 amendments to the UCC add an Official Comment that provides that if the borrower has granted a security interest to the agent in a deposit account maintained by the borrower with the agent (as depository bank), the agent's security interest is perfected automatically by control under UCC § 9-104(a)(1) and it is not necessary for the depository bank to enter into a control agreement with itself in its separate capacity as agent under UCC § 9-104(a)(2) in order for the security interest to be perfected by control. See Revised Official Comment 3 to UCC § 9-104; see also *Summary of the 2010 Amendments*.

The 2010 amendments also clarify that the failure of UCC § 9-104(a) to contain a provision analogous to UCC § 8-106(d)(3) (which provides for control of a security entitlement through a person acting on behalf of the secured party) does not suggest that a person with control of a deposit account may not also act as agent for a third party in order to perfect the secured party's interest by control through an agent. See Revised Official Comment 3 to UCC § 9-104; UCC § 1-103 (Former UCC § 1-103) (regarding the applicability of agency and other supplemental principals of law); see also *Summary of the 2010 Amendments*.

- (iii) the secured party becomes the bank's customer<sup>21</sup> with respect to the deposit account.<sup>22</sup>
- (b) UCC § 9-104(b) provides that a secured party that has satisfied UCC § 9-104(a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.
- (c) UCC § 9-341 provides that unless the bank otherwise agrees in an authenticated record, a bank's rights and duties with respect to a deposit account maintained with the bank are not terminated, suspended or modified by (1) the creation, attachment or perfection of a security interest in the deposit account, (2) the bank's knowledge of the security interest, or (3) the bank's receipt of instructions from the secured party.<sup>23</sup>
- (d) UCC § 9-342 provides that:
  - (i) Article 9 of the UCC does not require a bank to enter into a control agreement, even if its customer so requests or directs.
  - (ii) 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.

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<sup>21</sup> Note that becoming the bank's customer generally will require more than having the account titled in the name of the secured party.

<sup>22</sup> Delaware has added two non-uniform provisions that provide additional methods for obtaining control of a deposit account.

Section 9-104(a)(4) of the Delaware UCC provides that a secured party has control of a deposit account if "the debtor, secured party and bank have authenticated a record that (i) is conspicuously denominated a control agreement, (ii) identifies the specific deposit account in which the secured party claims a security interest, and (iii) contains one or more provisions addressing the disposition of funds in the deposit account or the right to direct the disposition of funds in the deposit account."

Section 9-104(a)(5) of the Delaware UCC provides that a secured party has control of a deposit account if "the name on the deposit account is the name of the secured party or indicates that the secured party has a security interest in the deposit account."

These alternative forms of control may not provide sufficient rights for the secured party to require the depository bank to dispose of funds as directed by the secured party in light of the limitations in UCC § 9-607. *See* Section 15 below.

<sup>23</sup> An exception is the limitation provided in UCC § 9-340(c) of the bank's set off rights if the secured party has perfected by control under UCC § 9-104(a)(3) by becoming the bank's customer with respect to the deposit account. *See* Section 9(b) below.

### 3. Control of a Certificated Security

- (a) UCC § 9-106(a) provides that a secured party has control of a certificated security as provided in UCC § 8-106.<sup>24</sup>
  - (i) UCC § 8-106(b) provides that a purchaser (including a secured party) has control of a certificated security in registered form<sup>25</sup> if:
    - (A) the certificated security is “delivered” to the purchaser; and
    - (B) the certificate is either:
      - (1) indorsed to the purchaser or in blank by an effective indorsement,<sup>26</sup> or
      - (2) registered in the name of the purchaser (upon original issue or registration of transfer by the issuer).<sup>27</sup>
- (b) UCC § 8-301(a) provides that “**delivery**” of a certificated security to a purchaser (including a secured party) occurs when:
  - (A) the purchaser acquires possession of the security certificate;
  - (B) another person, other than a securities intermediary, either acquires possession of the security certificate on behalf of the purchaser or, having previously acquired possession of the certificate, acknowledges that it holds for the purchaser; or
  - (C) a securities intermediary acting on behalf of the purchaser acquires possession of the security certificate, only if the certificate is in registered form and is (i) registered in the name of the purchaser, (ii) payable to the order of the purchaser, or (iii) specially indorsed to the purchaser by an effective indorsement and has not been indorsed to the securities intermediary or in blank.<sup>28</sup>

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<sup>24</sup> UCC §§ 8-106 and 8-301 (which deal with the concepts of control and delivery of investment property) refer to a purchaser having control or receiving delivery. As defined in UCC § 1-201(a)(32) and (33) (Former UCC § 1-201(32) and (33)), a “**purchaser**” includes a secured party.

<sup>25</sup> UCC § 8-106(a) provides that a secured party has control of a certificated security in bearer form if the certificated security is delivered to the secured party. Bearer certificates are generally not permitted in the United States under federal tax laws, and are therefore rarely encountered.

<sup>26</sup> UCC § 8-102(a)(11) defines “**indorsement**” as “a signature that alone or accompanied by other words is made on a security certificate in registered form or on a separate document for the purpose of assigning, transferring, or redeeming the security or granting a power to assign, transfer, or redeem it.” *See also* Official Comment 11 to UCC § 8-102. The indorsement may be on the certificate or a separate stock power, bond power or similar document.

UCC § 8-107 determines whether an indorsement is effective. UCC § 8-304 provides further discussion of the effect of an indorsement.

<sup>27</sup> If the certificate has been registered in the name of the secured party, the secured party will have control even if the indorsement was not effective. *See* UCC § 8-106(b).

<sup>28</sup> *See also* footnote 6 above.

#### 4. Control of an Uncertificated Security

- (a) UCC § 9-106(a) provides that a secured party has control of an uncertificated security as provided in UCC § 8-106.
- (b) UCC § 8-106(c) provides that a purchaser (including a secured party) has control of an uncertificated security if:
  - (i) the uncertificated security is delivered to the purchaser; or
  - (ii) the issuer has agreed that it will comply with instructions originated by the purchaser without further consent by the registered owner.<sup>29</sup>
- (c) UCC § 8-301(b) provides that “**delivery**” of an uncertificated security to a purchaser (including a secured party) occurs when:
  - (A) the issuer registers the purchaser as the registered owner, upon original issue or registration of transfer; or
  - (B) another person, other than a securities intermediary, either becomes the registered owner of the uncertificated security on behalf of the purchaser or, having previously become the registered owner, acknowledges that it holds for the purchaser.
- (d) UCC § 8-106(f) provides that a purchaser (including a secured party) who has satisfied the requirements of UCC § 8-106(c) has control even if the registered owner retains the right to make substitutions for the uncertificated security, to originate instructions to the issuer, or otherwise to deal with the uncertificated security.
- (e) UCC §8-106(g) provides that:
  - (i) An issuer may not enter into a control agreement without the consent of the registered owner.
  - (ii) An issuer is not required to enter into a control agreement, even if the registered owner so directs.
  - (iii) An issuer 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 the registered owner.

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<sup>29</sup> Delaware has added a non-uniform provision that provides a third method for obtaining control of an uncertificated security. Section 8-106(c)(3) of the Delaware UCC provides that a secured party has control of an uncertificated security if “the issuer, the registered owner and the purchaser [*i.e.* the secured party] have authenticated a record that (i) is conspicuously denominated a control agreement, (ii) identifies the uncertificated security in which the purchaser claims an interest, and (iii) contains one or more provisions addressing instructions relating to the uncertificated security or the right to originate instructions relating to the uncertificated security.”

This alternative form of control may not provide sufficient rights for the secured party to require the issuer to effect transfers in light of the limitations in UCC § 9-607. *See* Section 15 below.

## 5. Control of a Securities Account or Security Entitlement

### (a) Security Entitlements

- (i) UCC § 9-106(a) provides that a secured party has control of a security entitlement as provided in UCC § 8-106.
- (ii) UCC § 8-106(d) provides that a purchaser (including a secured party) has control of a security entitlement if:
  - (A) the purchaser becomes the entitlement holder;
  - (B) the securities intermediary<sup>30</sup> has agreed that it will comply with entitlement orders originated by the purchaser without further consent by the entitlement holder; or
  - (C) another person has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser.<sup>31</sup>
- (iii) UCC § 8-106(e) provides that if a security interest in a security entitlement is granted by the entitlement holder to the entitlement holder's own securities intermediary, the securities intermediary has control.<sup>32</sup>

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<sup>30</sup> There are some cases where it may not be clear which intermediary involved in maintaining a customer's securities account is the "securities intermediary" for purposes of UCC Article 8, in which case the safest course will be to have all intermediaries involved in the account relationship as parties to the control agreement. See H. Darmstadter, *Survey – Uniform Commercial Code: Investment Securities*, 65 BUS. LAW. 1283, 1283-85 (2010) (identification of securities intermediary in clearing broker arrangements).

<sup>31</sup> Delaware has added two non-uniform provisions that provides additional methods for obtaining control of a security entitlement or securities account.

Section 8-106(d)(4) of the Delaware UCC provides that a secured party has control of a security entitlement if "the securities intermediary, the entitlement holder and the purchaser [*i.e.* the secured party] have authenticated a record that (i) is conspicuously denominated a control agreement, (ii) identifies the security entitlement in which the purchaser claims an interest, and (iii) contains one or more provisions addressing entitlement orders relating to the security entitlement or the right to originate entitlement orders relating to the security entitlement."

In addition Section 9-106(d) of the Delaware UCC provides that a secured party has control of a securities account if "the name on the securities account is the name of the secured party or indicates that the secured party has a security interest in the securities account."

These alternative forms of control may not provide sufficient rights for the secured party to require the securities intermediary to effect transfers or dispositions of security entitlements in light of the limitations in UCC § 9-607. See Section 15 below.

<sup>32</sup> UCC § 8-106(e) refers only to automatic perfection of a security interest in a security entitlement, and does not provide for automatic perfection as to a securities account. UCC § 9-106(c) provides that a secured party has control of a securities account if it has control over all security entitlements carried in that account. As discussed in Section 5(b) below, Official Comment 4 to UCC § 9-108 contemplates that the concept of a securities account may include rights in addition to the security entitlements credited to the account.

- (iv) UCC § 8-106(f) provides that a purchaser (including a secured party) who has satisfied the requirements of § 8-106(d) has control even if the entitlement holder retains the right to make substitutions for the security entitlement, to originate entitlement orders to the securities intermediary, or otherwise to deal with the security entitlement.
  - (v) U.S. Treasury securities as well as other government and GSE (*e.g.* Fannie Mae and Freddie Mac) securities are generally issued through the indirect holding system (*i.e.* are generally a security entitlement when being used as collateral in a commercial transaction).<sup>33</sup>
- (b) Securities Accounts
- (i) A securities account is essentially the collection of security entitlements credited to the account. *See* UCC § 8-501; *see also* Official Comments to UCC § 8-501.
    - (A) However, Official Comment 4 to UCC § 9-108 contemplates that the concept of a securities account may include rights in addition to the security entitlements credited to the account.<sup>34</sup>
  - (ii) UCC § 9-106(c) provides that a secured party has control of a securities account if it has control over all security entitlements carried in that account.
  - (iii) Official Comment 4 to UCC § 9-106 states that a secured party also has control of a securities account if the securities intermediary has agreed with the secured party that it will (without further consent of the debtor) honor instructions from the secured party with respect to the securities account.
- (c) UCC § 8-106(g) provides that:
- (i) A securities intermediary may not enter into a control agreement without the consent of the entitlement holder.
  - (ii) A securities intermediary is not required to enter into a control agreement, even if the entitlement holder so directs.

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<sup>33</sup> The U.S. Treasury Department does maintain a system of holding Treasury securities directly on the records of the Treasury (referred to as “**Treasury Direct**”) that is generally only used by consumers; because of the limitations on securities held in that system they not are used as collateral in commercial transactions.

<sup>34</sup> Official Comment 4 to UCC § 9-108 states:

Note also given the broad definition of “securities account” in UCC § 8-501, a security interest in a securities account also includes all other rights of the debtor against the securities intermediary arising out of the securities account. For example, a security interest in a securities account would include credit balances due to the debtor from the securities intermediary, whether or not they are proceeds of a security entitlement.

- (iii) A securities intermediary 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 the entitlement holder.

## 6. Control of a Commodity Contract or Commodity Account

- (a) UCC § 9-106(b) provides that a secured party has control of a commodity contract if:
  - (i) the secured party is the commodity intermediary with which the commodity contract is carried; or
  - (ii) the commodity customer, secured party and commodity intermediary have agreed that the commodity intermediary will apply any value distributed on account of the commodity contract as directed by the secured party without further consent by the commodity customer.
- (b) UCC § 9-106(c) provides that a secured party has control of a commodity account if it has control over all commodity contracts carried in that account.
- (c) Official Comment 4 to UCC § 9-106 states that a secured party also has control of a commodity account if the commodity intermediary has agreed with the secured party that it will (without further consent of the debtor) honor instructions from the secured party with respect to the commodity account.

## 7. Control of a Letter-of-Credit Right

- (a) UCC § 9-107 provides that a secured party has control of a letter-of-credit right if the issuer or nominated person<sup>35</sup> has consented to the assignment of the proceeds of the letter of credit under UCC § 5-114(c).
  - (i) UCC § 5-114(c) provides that an issuer or nominated person need not recognize an assignment of letter of credit proceeds unless it has consented to the assignment.
  - (ii) UCC § 5-114(d) provides that an issuer or nominated person has no obligation to give or withhold its consent to an assignment of proceeds of a letter of credit, but consent may not be unreasonably withheld if the assignee possesses and exhibits the letter of credit and presentation of the letter of credit is a condition to honor.

## 8. Control of Electronic Chattel Paper or an Electronic Document

- (a) Electronic Chattel Paper.
  - (i) Specialized rules apply under UCC § 9-105.<sup>36</sup>

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<sup>35</sup> UCC § 5-102(a)(11) provides that a “**nominated person**” is a person whom the issuer: (A) designates or authorizes to pay, accept, negotiate or otherwise give value under a letter of credit, and (B) undertakes by agreement or custom and practice to reimburse.

<sup>36</sup> The 2010 amendments to the UCC modify the requirements for control of electronic chattel paper to conform them to those in UCC Article 7 for electronic documents of title and in the Uniform Electronic

- (b) Electronic Document.
  - (i) Specialized rules apply under UCC § 7-106.

## 9. Priority of Security Interests

- (a) General Rules.
  - (i) Control provides priority over other methods of perfection (*e.g.* filing, delivery (*i.e.* possession), proceeds).
  - (ii) First in time to obtain control has priority (but there are important exceptions).
  - (iii) Control is required for a secured party to qualify as a “protected purchaser” of a certificated or uncertificated security.<sup>37</sup> Similarly, with respect to security entitlements a secured party must be the holder of the security entitlement to qualify for the protection of the “free of claims” provisions in Part 5 of UCC Article 8.<sup>38</sup>
- (b) Deposit Accounts.
  - (i) UCC § 9-327(1) provides that a security interest in a deposit account perfected by control has priority over a security interest held by a person that does not have control. Therefore it has priority over a security interest perfected in the deposit account as proceeds of other collateral (even if that security interest was perfected earlier in time).
  - (ii) UCC § 9-327(2) provides that security interests in a deposit account perfected by control generally rank according to the time control was obtained.
  - (iii) UCC § 9-327(3) provides that a security interest of a bank in a deposit account maintained with that bank has priority over a conflicting security interest in that deposit account held by another secured party.

*Exception:* UCC § 9-327(3) provides that where the other secured party has obtained control over the deposit account under UCC § 9-104(a)(3) by becoming the bank’s customer with respect to the deposit account that secured party has

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Transactions Act (UETA) for transferable records. The result is that the amended version of UCC § 9-105 sets forth the current requirements as a “safe harbor” but permits other control systems as well. *See* Revised UCC § 9-105(a)-(b); *see* UCC § 7-106 and UETA § 16; *see also* *Summary of the 2010 Amendments*.

The 2010 amendments also clarify that if chattel paper consist of both tangible and electronic records that a secured party’s security interest is perfected by control when it has possession of the tangible records and control of the electronic records. *See* Revised Official Comment 4 to UCC § 9-330; *see also* *Summary of the 2010 Amendments*.

<sup>37</sup> *See* Section 10 below.

<sup>38</sup> *See* Section 10 below.



priority over a security interest held by the bank with which the deposit account is maintained.

- (iv) Therefore, if a secured party has perfected its security interest in a deposit account by a control agreement to which the bank is a party, and even though that perfection took place before the bank was granted a security interest in the deposit account, the bank's security interest will have priority over the secured party's security interest.<sup>39</sup>
- (v) UCC §§ 9-340 and 9-341 provide that a bank will (except in the case where the secured party has perfected its security interest in a deposit account under UCC § 9-104(a)(3) by becoming the bank's customer with respect to the deposit account) retain its right of recoupment or set-off against a deposit account maintained with it unless it agrees otherwise (either in the applicable control agreement or in a separate document).
- (vi) UCC § 9-340(a) provides that the setoff and recoupment rights of a bank where a deposit account is maintained have priority over a security interest in that deposit account, even if perfected by control. *See also* Official Comment 2 to UCC § 9-340.

*Exception:* Where the secured party has obtained control over the deposit account under UCC § 9-104(a)(3) by becoming the bank's customer with respect to the deposit account the bank may not effectively exercise its rights of setoff with respect to a debt owed by the debtor. The bank's rights of recoupment may still be effectively exercised. UCC § 9-340(c); *see also* Official Comment 2 to UCC § 9-340.<sup>40</sup>

- (vii) 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

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<sup>39</sup> A depository bank does not automatically have a security interest in a deposit account. The security interest must be granted by the debtor, as provided in UCC § 9-203 and the definition of "security agreement" in UCC § 9-102(a)(73), although it need not be evidenced by an authenticated record under the exception provided in UCC § 9-203(b)(3)(D). If the depository bank has a security interest, that security interest is automatically perfected by control under UCC § 9-104 (as discussed in Section 2 above).

<sup>40</sup> "Recoupment" is distinguished from "set off":

A "set-off" is a demand which the defendant has against the plaintiff, arising out of a transaction extrinsic to the plaintiff's cause of action, whereas a "**recoupment**" is a **reduction or rebate** by the defendant of part of the plaintiff's claim because of a right in the defendant **arising out of the same transaction**.

BLACK'S LAW DICTIONARY 1275 (6th 1990) (emphasis added).

transferee acts in collusion with the debtor in violating the rights of the secured party. *See also* Official Comments to UCC § 9-332.

- (c) **Certificated Securities.**
  - (i) UCC § 9-328(1) provides that a security interest in investment property perfected by control has priority over a security interest held by a person that does not have control. Therefore a security interest in a certificated security perfected by control has priority over a security interest perfected by filing, by delivery or as proceeds (even if that security interest was perfected earlier in time).
  - (ii) UCC § 9-328(5) provides that a security interest in a certificated security in registered form that is perfected by taking delivery under UCC § 9-313(a) and not by control under UCC § 9-314 has priority over a conflicting security interest perfected by a method other than control (*i.e.* by filing or as proceeds).
- (d) **Uncertificated Securities.**
  - (i) UCC § 9-328(1) provides that a security interest in investment property perfected by control has priority over a security interest held by a person that does not have control. Therefore a security interest in an unperfected security perfected by control has priority over a security interest perfected by filing or as proceeds (even if that security interest was perfected earlier in time).
  - (ii) UCC § 9-328(2) provides that security interests perfected by control generally rank according to the time control is obtained (subject to exceptions provided in that section).
- (e) **Security Entitlements and Securities Accounts.**
  - (i) UCC § 9-328(1) provides that a security interest in investment property perfected by control has priority over a security interest held by a person that does not have control. Therefore a security interest in a security entitlement or a securities account perfected by control has priority over a security interest perfected by filing or as proceeds (even if that security interest was perfected earlier in time).
  - (ii) UCC § 9-328(2) provides that security interests perfected by control rank according to the time control is obtained (subject to exceptions provided in that section).
  - (iii) UCC § 9-328(3) provides that 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.
  - (iv) Therefore, even if a secured party has perfected its security interest in a security entitlement or a securities account by a control agreement to which the securities intermediary is a party, and even though that perfection took place before the securities intermediary was granted a

security interest in the security entitlement or the securities account, the securities intermediary's security interest will have priority over the secured party's security interest.<sup>41</sup>

- (f) **Commodity Contracts and Commodity Accounts.**
  - (i) UCC § 9-328(1) provides that a security interest in investment property perfected by control has priority over a security interest held by a person that does not have control. Therefore security interest in a commodity contract or a commodity account by control has priority over a security interest perfected by filing or as proceeds (even if that security interest was perfected earlier in time).
  - (ii) UCC § 9-328(2) provides that security interests perfected by control rank according to the time control is obtained (subject to exceptions provided in that section).
  - (iii) UCC § 9-328(4) provides that a security interest held by a commodity intermediary in a commodity contract or a commodity account maintained with the commodity intermediary has priority over a conflicting security interest held by another secured party.
  - (iv) Therefore, even if a secured party has perfected its security interest in a commodity contract by a control agreement to which the commodity intermediary is a party, and even though that perfection took place before the commodity intermediary was granted a security interest in the commodity contract, the commodity intermediary's security interest will have priority over the secured party's security interest.<sup>42</sup>
- (g) **Letter-of-Credit Rights.**
  - (i) UCC § 9-329(1) provides that a security interest in letter-of-credit rights held by a secured party having control of the letter-of-credit rights has priority to the extent of its control over a security interest held by a person that does not have control. Therefore it has priority over a security interest automatically perfected as to supporting obligations or as proceeds (even if that security interest was perfected earlier in time).

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<sup>41</sup> A securities intermediary does not automatically have a security interest in a security entitlement or securities account. The security interest must be granted by the debtor, as provided in UCC § 9-203 and the definition of "security agreement" in UCC § 9-102(a)(73), although it need not be evidenced by an authenticated record under the exception provided in UCC § 9-203(b)(3)(D). If the securities intermediary has a security interest in a security entitlement, that security interest is automatically perfected by control under UCC § 8-106 (as discussed in Section 5 above).

<sup>42</sup> A commodity intermediary does not automatically have a security interest in a commodity contract or commodity account. The security interest must be granted by the debtor, as provided in UCC § 9-203 and the definition of "security agreement" in UCC § 9-102(a)(73), although it need not be evidenced by an authenticated record under the exception provided in UCC § 9-203(b)(3)(D). If the commodity intermediary has a security interest in a commodity contract, that security interest is automatically perfected by control under UCC § 9-106(b) (as discussed in Section 6 above).

- (ii) UCC § 9-329(2) provides that security interests perfected by control rank according to the time control was obtained.
- (iii) UCC § 5-114(e) provides that the rights of a transferee beneficiary or nominated person are independent of the beneficiary's assignment of the proceeds of a letter of credit and are superior to the assignee's right to the proceeds.<sup>43</sup>
- (h) Electronic chattel paper.
  - (i) UCC § 9-330 provides the priority rules with respect to security interests in and the rights of buyers of electronic chattel paper.
- (i) Electronic documents.
  - (i) UCC § 9-331 provides that UCC Article 9 does not limit the rights of a holder<sup>44</sup> to which a negotiable document of title has been duly negotiated – such a holder takes priority over an earlier security interest, even if perfected, to the extent provided in UCC Article 7.

#### 10. Protected Purchaser Status and “Takes Free” Rules

- (a) UCC Article 8 provides protections to a secured party that obtains control of a certificated or uncertificated security and meets other specified requirements. Under UCC § 8-303 such a secured party is a “protected purchaser” and takes free of adverse claims.<sup>45</sup>
- (b) Equivalent protections are provided to a person that becomes the holder of a security entitlement. UCC §§ 8-502, 8-503 and 8-510.<sup>46</sup>
- (c) Where the protected purchaser is a secured party, a previously perfected security interest in a security will be subordinated (by operation of UCC § 9-328) rather than extinguished by the protected purchase rule (or equivalent concepts for security entitlements) in UCC Article 8.<sup>47</sup>

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<sup>43</sup> In addition, UCC § 4-210 gives first priority to a collecting bank that has given value for a documentary draft. *See* Official Comment 2 to UCC § 5-114.

<sup>44</sup> UCC § 1-201(a)(21) defines “**holder**” to include the person in control of a negotiable electronic document of title.

<sup>45</sup> The protection provided by UCC § 8-303 is recognized in Article 9. *See* UCC § 9-331(a) and Official Comment 2 to UCC § 9-331.

<sup>46</sup> The protection provided by UCC §§ 8-502, 8-503 and 8-510 are recognized in Article 9. *See* UCC § 9-331(b) and Official Comment 4 to UCC § 9-331.

<sup>47</sup> *See* Official Comment 2 to UCC § 9-331, which states that “whether a holder or purchaser referred to in Section 9-331 takes free or is senior to a security interest depends on whether the purchaser is a buyer of the collateral or takes a security interest in it.”

A more detailed discussion of protected purchaser and “free of claims” provisions of Article 8 of the UCC and related matters is included in the article “Equity Interests as Collateral” that accompanies this outline.

## 11. Choice of Law

- (a) Attachment (Creation) of a Security Interest.
  - (i) UCC § 1-301 (Former § 1-105) – Forum state<sup>48</sup> will honor the parties’ choice of law in their agreement:
    - (A) If transaction meets “reasonable relation” test.
    - (B) As to matters governed by another Article of the UCC.
    - (C) As to relationship of the parties (not third party rights).
  - (ii) Other state statutes may apply to choice of law to govern creation:
    - (A) NY GOL § 5-1401 (upholding parties’ choice of NY law if size of transaction test is met).<sup>49</sup>
    - (B) California Civil Code § 1646.5.
    - (C) Tex. Bus. & Com. Code § 35.51.
- (b) Perfection, the Effect of Perfection or Nonperfection, and Priority
  - (i) Mandatory Choice of Law Provisions in UCC §§ 9-301 to 9-307.<sup>50</sup>
  - (ii) Depends on method of perfection used and type of collateral – ***with respect to perfection by control***:
    - (A) Deposit Accounts (UCC § 9-304).
      - (1) Local law of the bank’s jurisdiction governs perfection, the effect of perfection or nonperfection, and priority (UCC § 9-304(a)).
      - (2) Bank’s jurisdiction is determined as provided in UCC § 9-304(b) – generally will be established by the control agreement.
    - (B) Investment Property (Certificated and Uncertificated Securities; Security Entitlements and Securities Accounts; Commodity Contracts and Commodity Accounts) (UCC § 9-305).
      - (1) *Certificated Security*: local law of the jurisdiction where a certificated security is located governs perfection, the effect

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<sup>48</sup> Note that the UCC choice of law rules will not apply to a jurisdiction that has not enacted the UCC (*e.g.* before a non-US tribunal).

<sup>49</sup> See discussion of enforceability of New York choice of law under GOL § 5-1401 in the absence of a connection of the transaction with New York in *Special Report of the TriBar Opinion Committee: The Remedies Opinion – Deciding When to Include Exceptions and Assumptions*, 59 BUS. LAW. 1483, 1495-98 and notes 64-70 (2004), reprinted in COLLECTED ABA AND TRIBAR OPINION REPORTS (2009) and available at <http://apps.americanbar.org/buslaw/tribar>. Note that a non-New York court will not be bound by New York GOL 5-1401.

<sup>50</sup> See UCC § 1-301 (Former UCC § 1-105). Note that the UCC choice of law rules will not apply to a jurisdiction that has not enacted the UCC (*e.g.* before a non-US tribunal).

- of perfection or nonperfection, and priority (UCC § 9-305(a)(1)).
- (2) *Uncertificated Security*: local law of the issuer’s jurisdiction (as specified in UCC § 8-110(d)) governs perfection, the effect of perfection or nonperfection, and priority (UCC § 9-305(a)(2)).
  - (3) *Security Entitlement/Securities Account*: local law of the securities intermediary’s jurisdiction governs perfection, the effect of perfection or nonperfection, and priority (UCC § 9-305(a)(3)).
    - (aa) Securities intermediary’s jurisdiction is determined as provided in UCC § 8-110(e) – generally will be established by the control agreement.
    - (bb) Automatic perfection (where debtor is a broker or a securities intermediary) is governed by local law of the jurisdiction of the debtor’s location (UCC §§ 9-305(c)(2), 9-307).
  - (4) *Commodity Contract/Commodity Account*: local law of the commodity intermediary’s jurisdiction governs perfection, the effect of perfection or nonperfection, and priority (UCC § 9-305(a)(4)).
    - (aa) Commodity intermediary’s jurisdiction is determined as provided in UCC § 9-305(b) – generally will be established by the control agreement.
    - (bb) Automatic perfection (where debtor is a commodity intermediary) is governed by local law of the jurisdiction of the debtor’s location (UCC §§ 9-305(c)(2), 9-307).
- (C) Letter-of-Credit Rights.
- (1) The local law of the issuer’s jurisdiction or a nominated person’s jurisdiction governs perfection, the effect of perfection or nonperfection, and priority in a letter-of-credit right if the issuer’s or nominated person’s jurisdiction is a State<sup>51</sup> (UCC § 9-306(a)).
    - (aa) An issuer’s jurisdiction or a nominated person’s jurisdiction is the jurisdiction whose law governs the liability of the issuer or nominated person with

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<sup>51</sup> “**State**” is defined in UCC § 9-102(a)(76) as “a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.”

respect to the letter-of-credit right as provided in UCC § 5-116 (UCC § 9-306(b)) – generally will be established by the terms of the letter of credit itself (*see* Official Comment 2 to UCC § 9-306).

(2) If the issuer’s or a nominated person’s jurisdiction is not a State, then the general rule (set out in UCC § 9-301(1)) applies that perfection, the effect of perfection or nonperfection, and priority will be determined by the location of the debtor (Official Comment 2 to UCC § 9-306, § 9-307).

(D) Electronic chattel paper and electronic documents.

(1) The general rule applies that perfection, the effect of perfection or nonperfection, and priority will be determined by the location of the debtor (UCC §§ 9-301(1), 9-307).

## 12. Collateral Description and Collateral Indication

(a) UCC § 9-108 establishes rules for a legally sufficient description of collateral in a security agreement.

(i) UCC § 9-108(a) provides that (except as otherwise provided in UCC § 9-108(c),<sup>52</sup> (d) and (e)) a description of personal property is sufficient, whether or not it is specific, if it reasonably identifies what is described.

(ii) UCC § 9-108(b) provides examples of reasonable description – except as otherwise provided in UCC § 9-108(d) a description of collateral reasonably identified the collateral if it identifies the collateral by:

(A) Specific listing;

(B) Category;

(C) Except as otherwise provided in UCC § 9-108(e), a type of collateral defined in the UCC (*e.g.* deposit account, investment property);

(D) Quantity;

(E) Computational or allocational formula or procedure; or

(F) Except as otherwise provided in UCC § 9-108(e), any other method, if the identity the collateral is objectively determinable.

(iii) UCC § 9-108(d) provides that except as otherwise provided in UCC § 9-108(e) a description of a security entitlement, securities account or commodity account is sufficient if it describes:

(A) the collateral by those terms or as investment property, or

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<sup>52</sup> UCC § 9-108(c) provides that a description of collateral in “supergeneric” terms (*e.g.* as “all of the debtor’s assets” or “all of the debtor’s personal property” or using words of similar import) does not reasonably identify the collateral.

- (B) the underlying financial asset<sup>53</sup> or commodity contract.
- (iv) UCC § 9-108(e)(2) provides that in a consumer transaction<sup>54</sup> a description only by type of collateral defined in the UCC is an insufficient description of a security entitlement, a securities account or a commodity contract. *See also* Official Comment 5 to UCC § 9-108.
- (b) UCC § 9-504 establishes rules for a legally sufficient indication of collateral in a financing statement (generally tracking UCC § 9-108).<sup>55</sup>

### 13. Additional Considerations

- (a) Perfection by Control.
  - (i) Physical possession of certificated securities:
    - (A) Debtor cannot sell the pledged security to a protected purchaser who takes free of the security interest.<sup>56</sup>
    - (B) A subsequent secured party cannot obtain control (and control priority) of the pledged security.<sup>57</sup>
  - (ii) Re-registration of certificated security in the name of the secured party:
    - (A) Even if indorsement of the security is ineffective, secured party has control.
    - (B) Dividends and distributions are paid to record holder and record holder exercises voting rights.
  - (iii) Uncertificated security transferred into the name of the secured party on the books of the issuer:

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<sup>53</sup> As noted in Section 5(b) above, Official Comment 4 to UCC § 9-108 contemplates that the concept of a securities account may include rights in addition to the security entitlements credited to the account.

<sup>54</sup> *See* note 2 above for the definition of consumer transaction.

<sup>55</sup> Unlike the requirements of UCC § 9-108 with respect to the sufficiency of a collateral description included in a security agreement, however, “supergenerics” (*see* footnote 52 above) are permitted in the indication of collateral in a financing statement. *See* UCC § 9-504(2).

<sup>56</sup> The secured party can be adversely affected if the debtor falsely claims that the certificate (in fact in the possession of the secured party or a third party) was lost, destroyed or stolen and obtains a replacement (which could result in dilution of the value of the secured party’s collateral if a protected purchaser acquires rights in the new certificate). *See* Section 8-405(b). While the issuer has the right to require a bond before it issues a replacement certificate (which would protect against the economic dilution), in some cases the issuer does not enforce this requirement. This risk can be mitigated by notifying the issuer that the certificate has been pledged and is in the possession of the secured party or third party, and by having the issuer agree that it will not issue a replacement certificate without the secured party’s consent.

<sup>57</sup> It is theoretically possible that one secured party could have only perfection by delivery, while another could have perfection by control (and therefore have priority) if the certificate is in the possession of a third party acting on behalf of each secured party.



- (A) Dividends and distributions are paid to record holder and record holder exercises voting rights.
- (iv) Security entitlements in an account in the name of the secured party:
  - (A) Protection against securities intermediary's failing to identify/implement limits on debtor's rights to give investment instructions and/or order funds or investments be delivered out of the account.
  - (B) Not protection against securities intermediary's failure to maintain sufficient assets (including entitlements at upper-tier intermediaries) to cover the entitlements credited to the securities account, failure of upper-tier intermediaries to maintain sufficient assets, etc.
- (v) Deposit account in the name of the secured party:
  - (A) Protection against depository bank's failing to identify/implement limits on debtor's rights to direct that funds be delivered out of the account.
  - (B) Protection against depository bank right of setoff against the debtor.
  - (C) Not protection against credit risk of the depository bank.<sup>58</sup>
- (vi) Administrative considerations:
  - (A) Is this an operating account or account in which there are investments to be actively managed?
  - (B) Does the secured party have the ability to handle debtor requests for funds/trades on a timely basis?
  - (C) Lender liability and tax reporting considerations.
- (vii) Business considerations:
  - (A) Is this collateral that the secured party is relying on in its underwriting and collateral requirements?
  - (B) Time and cost considerations.
- (b) Perfection by control eliminates requirement for security agreement to be evidenced by an authenticated record.
  - (A) UCC § 9-203(b)(3)(C) and (D) permit delivery or control of certain collateral to substitute for an authenticated record evidencing the security agreement between the parties.
  - (B) There must still be a security agreement as defined in UCC § 9-102(a)(73) – this is merely a “statue of frauds” exception.

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<sup>58</sup> The CDARs program (holding a diversified pool of certificates of deposit, in amounts that can be fully FDIC-insured, as security entitlements in a securities account) was developed to mitigate this credit risk.

- (C) For most transactions this exception is not relied upon given the evidentiary issues it creates.

#### 14. Rights and Duties of Secured Party Having Control of Collateral

- (a) Release of Proceeds to the Debtor Unless Otherwise Agreed:
  - (i) UCC § 9-207(c)(2) provides that a secured party that has possession or control of collateral shall either:
    - (A) apply money or funds received from the collateral to reduce the secured obligation, or
    - (B) remit such money or funds to the debtor.<sup>59</sup>
  - (ii) UCC § 1-302 (Former § UCC 1-201(3) and (4)) provides that the requirements of UCC § 9-207(c)(2) may be varied by agreement of the secured party and the debtor.<sup>60</sup>
- (b) Secured Party's Right of Repledge
  - (i) UCC § 9-207(c)(3) provides that a secured party with control of collateral “may create a security interest in the collateral.”<sup>61</sup>

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<sup>59</sup> As provided in UCC § 9-207(c)(1) the secured party may hold as additional security any proceeds other than money or funds.

<sup>60</sup> See UCC § 9-602 (listing sections of UCC Article 9 that cannot be waived or varied by agreement, which do not include UCC § 9-207(c)).

<sup>61</sup> For example, this provision permits a stock broker to use its customer's securities securing “margin” loans by the broker to the customer as collateral for loans to the broker.

Official Comment 6 to UCC § 9-207 provides a further example of a secured party's right of repledge:

**‘Repledges’ of Investment Property.** The following example will aid the discussion of “repledges” of investment property.

**Example.** Debtor grants Alpha Bank a security interest in a security entitlement that includes 1000 shares of XYZ Co. stock that Debtor holds through an account with Able & Co. Alpha does not have an account with Able. Alpha uses Beta Bank as its securities custodian. Debtor instructs Able to transfer the shares to Beta, for the account of Alpha, and Able does so. Beta then credits Alpha's account. Alpha has control of the security entitlement for the 1000 shares under Section 8-106(d). (These are the facts of Example 2, Section 8-106, Comment 4.) Although, as between Debtor and Alpha, Debtor may have become the beneficial owner of the new security entitlement with Beta, Beta has agreed to act on Alpha's entitlement orders because, as between Beta and Alpha, Alpha has become the entitlement holder.

Next, Alpha grants Gamma Bank a security interest in the security entitlement with Beta that includes the 1000 shares of XYZ Co. stock. In order to afford Gamma control of the entitlement, Alpha instructs Beta to transfer the stock to Gamma's custodian, Delta Bank, which credits Gamma's account for 1000 shares. At this point Gamma holds its security

## 15. Enforcement of Secured Party Remedies

- (a) Without control of the collateral the secured party may have difficulty effecting a transfer of its collateral or exercising other remedies following default.
- (b) UCC § 9-607 determines the rights between the secured party and the debtor in the exercise of secured party remedies, but not the duties of an account debtor, bank or other person obligated on the collateral.
  - (i) In the case of an account debtor, bank or other obligor, other provisions of Article 9, other law or an agreement will determine the rights of the secured party against such person. *See* UCC § 9-607(e) and Official Comments 6 and 7 to UCC § 9-607.<sup>62</sup>
  - (ii) The issuer of a security may not be obligated to deal with the secured party absent control. *See* UCC § 9-607(e), OC 6 to UCC § 9-607, UCC §§ 9-406, 9-408, 8-204, 8-401.
  - (iii) If a security interest in securities entitlements or a securities account is not perfected by control, the securities intermediary ordinarily owes no obligation to obey the secured party's instructions. In such circumstances, to reach the funds without the debtor's cooperation the secured party must use an available judicial procedure. *See* Official Comment 3 to UCC § 8-507; UCC § 9-607(e) and Official Comment 6 to UCC § 9-607
- (c) A secured party that has perfected by control of collateral will have the rights provided by taking control and (if applicable) the terms of the related control agreement.<sup>63</sup>
  - (i) A secured party that has a security interest in a deposit account perfected by control under UCC § 9-104(a)(1) (by being the depository bank where the account is maintained) may apply the balance of the deposit account to the obligation secured by the deposit account. *See* UCC § 9-607(a)(4).

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entitlement for its benefit as well as that of its debtor, Alpha. Alpha's derivative rights also are for the benefit of Debtor.

UCC § 8-504(b) contemplates that, with the permission of its customer, a securities intermediary may pledge financial assets that it holds for that customer to secure credit extended to the securities intermediary. *See also* Official Comment 2 to UCC § 8-504 for a discussion of a securities intermediary's ability to pledge customer securities.

<sup>62</sup> While UCC § 9-406(a) provides the secured party with direct collection rights with respect to certain types of collateral (subject to the limitations specified in UCC § 9-406), it does not apply to investment property or a deposit account.

*See also* Sections 2 and 7 above regarding limitations on enforcement with respect to letter-of-credit rights and deposit accounts in the absence of control over collateral.

<sup>63</sup> As discussed in notes 22, 29 and 31 above, Delaware has adopted nonuniform provisions of UCC §§ 8-106 and 9-104 with respect to methods of obtaining control. While these nonuniform Delaware provisions may permit an agreement to meet the requirements for perfection by control, they may not require the issuer of an uncertificated security, a securities intermediary or a depository bank to comply with instructions of the secured party.

- (ii) A secured party that has a security interest in a deposit account perfected by control under UCC § 9-104(a)(2) or (3) (through a control agreement or by becoming the bank’s customer with respect to the deposit account) may instruct the bank to pay the balance of the deposit account to or for the benefit of the secured party. *See* UCC § 9-607(a)(5).

## 16. Legal Opinions

- (a) Creation of Security Interest.
  - (i) General – use standard creation/attachment language and qualifications.
  - (ii) Special collateral description rule for consumer transactions (*see* UCC § 9-108(e)(2) and Official Comment 5 to UCC § 9-108) – determine if additional qualifications to the opinion are needed.
  - (iii) While a secured party can under specified circumstances acquire a security interest in securities and security entitlements in which the debtor does not have rights, that is commonly dealt with by giving a “protected purchaser” opinion (described below) and not by changing the form of or qualifications to the creation opinion.
  - (iv) Choice of law – *see* Section 11(a) above.
- (b) Perfection of Security Interest.
  - (i) *Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions – Revised Article 9*<sup>64</sup> discusses a “perfection by control” opinion and provides model language and qualifications.
  - (ii) Opinion is based on whether the legal requirements for control are met under the applicable provisions of UCC Article 9, as described in Sections 2, 3, 4, 5, 6, 7 and 8 above.
  - (iii) Opinion generally does not address whether the collateral is in fact of a specific type (*e.g.* a deposit account or securities account).
  - (iv) Choice of law – *see* Section 11(b) above.
- (c) Control Priority.
  - (i) *TriBar Report on Security Interest Opinions* discusses a “priority resulting from control” opinion and provides model language and qualifications.
  - (ii) Opinion is based on whether the legal requirements for control are met under the applicable provisions of UCC Article 9, as described in Sections 2, 3, 4, 5, 6, 7 and 8 above.
  - (iii) Opinion generally does not address whether the collateral is in fact of a specific type (*e.g.* a deposit account or a securities account).

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<sup>64</sup> *Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions – Revised Article 9*, 58 BUS. LAW. 1449 (2003), *reprinted in* Collected ABA and TriBar Opinion Reports (2009) and available at <http://apps.americanbar.org/buslaw/tribar> (hereinafter “*TriBar Report on Security Interest Opinions*”).

- (iv) Choice of law – *see* Section 11(b) above.
- (d) Protected Purchaser or “Takes Free” Opinion.
  - (i) *TriBar Report on Security Interest Opinions* discusses “protected purchaser” (and equivalent for security entitlements) opinions and provides model language and qualifications.<sup>65</sup>
  - (ii) Opinion is based on whether the legal requirements for “protected purchaser” status under UCC 8-303 (or the equivalent with respect to a security entitlement under UCC §§ 8-502, 8-503 and 8-510) are met, as described in Section 10 above.
  - (iii) Choice of law – *see* Section 11(b) above.

## 17. Control Agreements

- (a) General.
  - (i) Most depository banks, issuers of uncertificated securities, securities intermediaries, letter of credit issuers and commodity intermediaries will have their own control agreements.
    - (A) Before spending time preparing an agreement based on a model or form, find out if this is the case.
    - (B) Some of the banks that participated in the drafting of the ABA model deposit account control agreement (referenced in Section 17(b) below) have agreed to accept it.
  - (ii) Use models and forms as a template to assess whether a proposed document provided by another party contains appropriate terms and provisions (and the effect of specific terms and provisions or the omission of specific terms and provisions).
- (b) Deposit Accounts.
  - (i) The ABA Business Law Section has published a model deposit account control agreement with commentary, as well as variations to apply to specific types of transactions (including securitizations) and to adapt the model agreement to meet the regulatory restrictions applicable to certain healthcare insurance receivables.
  - (ii) The forms and commentary can be accessed at <http://apps.americanbar.org/dch/committee.cfm?com=CL710060> .
- (c) Securities Accounts and Security Entitlements.

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<sup>65</sup> TriBar has prepared a report, which will be published in 2011, on opinions as to protected purchaser status (and the equivalent protections for security entitlements) in the context of secondary sales of securities. While that report expressly states that it does not address those concepts in the context of a secured transaction, the report does provide a detailed analysis of the relevant provisions of UCC Article 8 (including the differences between the treatment of securities (certificated and uncertificated) and security entitlements).

- (i) *Forms Under Revised Article 9 (2d Ed.)* contains a form of securities account control agreement with commentary.
  - (ii) A similar form with commentary is included in the materials that accompany this outline.
- (d) Uncertificated Securities.
  - (i) An example is included in the materials that accompany this outline.
- (e) Letter-of-Credit Rights.
  - (i) *Forms Under Revised Article 9 (2d Ed.)* contains a form of letter-of-credit rights control agreement with commentary.

## **Exhibit A**

### **General Information Regarding the UCC Official Text and Comments**

References in the outline and this exhibit to the “UCC” are to the current Official Text (and Official Comments) of the Uniform Commercial Code as in effect on the date of these materials. The outline generally does not address variations from the Official Text and Comments in a specific jurisdiction’s enactment of the UCC (or supplementary commentary provided in some states).

As of the date of these materials Revised UCC Article 1 has not been adopted in all jurisdictions. Where sections of Revised UCC Article 1 are cited, the equivalent provisions of Former UCC Article 1 (if any) are noted in parentheses. There are few substantive differences between the Official Text of Revised and Former UCC Article 1, but there are some differences between the two versions. In addition, there may be variations from the Official Text in the enactment of UCC Article 1 in a specific jurisdiction.

As of the date of these materials, UCC Article 8 as enacted in all jurisdictions is relatively consistent with the Official Text of UCC Article 8. Certain nonuniform provisions of the Delaware enactment of UCC Article 8 are described in the footnotes to the outline.

In most jurisdictions UCC Article 9 as enacted contains significant non-uniformities from the Official Text of UCC Article 9. Certain nonuniform provisions of the Delaware enactment of UCC Article 9 are described in the footnotes to the outline.

In 2010 the Official Text of UCC Article 9 (including the Official Comments to UCC Articles 8 and 9) was amended. The amendments to the Official Text of UCC Article 9 (and related changes to the Official Comments) will not become effective in any jurisdiction until enacted in that jurisdiction (and may be enacted with variations from the uniform text). The planned effective date of these amendments is July 1, 2013 (though enacting jurisdictions may specify a different effective date). The 2010 changes to the Official Comments that are not related to an amendment to the statutory provisions of the Official Text of UCC Article 9 have become effective. Relevant provisions of the 2010 amendments (including changes to the Official Comments) are discussed in the footnotes to the outline.

Because of nonuniformities in the UCC as enacted in specific jurisdictions, as well as the need to determine the governing law for purposes of rendering legal opinions, it is important to understand the applicable choice of law provisions (discussed in Section 11 of the outline) and to review not only the Official Text of the UCC but also the text of the UCC as enacted in the relevant jurisdiction(s) and in effect at the relevant time.

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*This is a work in progress – comments and questions are welcome*

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Topic	Deposit Account	Securities Account
Definitions	<p>9-102(a)(29) – “Deposit account” means 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.<sup>1</sup></p> <p>9-102(a)(8) – “Bank” means an organization that is engaged in the business of banking. The term includes savings banks, savings and loan associations, credit unions, and trust companies.</p>	<p>9-102(b) refers to 8-501 for the definition of securities account and to 8-102 for the definitions of financial asset, securities intermediary, security entitlement, entitlement holder and other terms defined in Article 8. Investment property is defined in 9-102(a)(49) and includes a securities account and security entitlements.</p> <p>8-501(a) – “Securities account” means an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset.</p> <p>8-102(a)(14) – “Securities intermediary” means: (i) a clearing corporation; or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.</p> <p>8-102(a)(17) – “Security entitlement” means the rights and property interest of an entitlement holder with respect to a financial asset specified in Part 5 [of Article 8].<sup>2</sup></p> <p>8-102(a)(7) – “Entitlement holder” means a person identified in</p>

<sup>1</sup> OC 12 to 9-102 discusses the exclusion of deposit accounts represented by an instrument.

<sup>2</sup> See Prefatory Notes II.C and III.B to Article 8 for a discussion of the concept of a security entitlement.



Topic	Deposit Account	Securities Account
		the records of a securities intermediary as the person having a security entitlement against the securities intermediary. If a person acquires a security entitlement by virtue of 8-501(b)(2) or (3), that person is the entitlement holder.
The Line between Deposit Account and Securities Account? <sup>3 4</sup>	<p><i>Guidance provided by Article 9:</i> Shares in a money-market mutual fund, even if the shares are redeemable by check, are not a deposit account. OC 12 to 9-102.</p>	<p><i>Guidance provided by Article 8:</i> An ordinary bank deposit account would not fall within the definition of security in 8-102(a)(15), nor would the relationship between a bank and its depositor be a security entitlement under Part 5 of Article 8. One of the basic elements of the relationship between a securities intermediary and an entitlement holder is that the securities intermediary has the duty to hold exactly the quantity of securities that it carries for the account of its customer, the entitlement holder (<i>see</i> 8-504). The assets that a securities intermediary holds for its customer are not assets that it can use in its proprietary business (<i>see</i> 8-503). A deposit account is an entirely different arrangement. A bank is not required to hold in its vaults or in deposit accounts with other banks a sum of money equal to the claims of all of its depositors. Banks are permitted to use depositors' funds in their ordinary lending business; indeed, that is a primary function of banks. A deposit account, unlike a securities account, is simply a debtor-creditor relationship. <i>See</i> Prefatory Note III.C.4 to Article 8. <i>See also</i> OC 3 to 8-504 ("The statement in this section that an intermediary must obtain and maintain financial assets corresponding to the aggregate of all</p>

<sup>3</sup> This determination will affect matters including scope (*see* "Scope" below), collateral description (*see* "Collateral Description" below) and method of perfection (*see* "Method of Perfection" below) and may affect the applicability of provisions that treat cash proceeds differently from noncash proceeds (*see* "Is the Account 'Cash Proceeds'?" below)

<sup>4</sup> Cases that addressed whether an account was a deposit account for purposes of former Article 9 include *In re Nix*, 864 F.2d 1209 (5th Cir. 1989) (Keogh retirement plan maintained with a stock broker not a deposit account) and *In re Van Kylan*, 98 B.R. 455 (Bankr. W.D. Wis. 1989) (cash management account with a broker not a deposit account; court also analyzed separately the securities held in the account, applying former Article 8).

Topic	Deposit Account	Securities Account
		<p>security entitlements it has established is intended only to capture the general point that one of the key elements that distinguishes securities accounts from other relationships, such as deposit accounts, is that the intermediary undertakes to maintain a direct correspondence between the positions it holds and the claims of its customers."), OC 1 to 8-501.</p> <p>Prefatory Note III.C.4 to Article 8 also states that: "Today, it is common for brokers to maintain securities accounts for their customers which include arrangements for the customers to hold liquid 'cash' assets in the form of money market mutual fund shares. Insofar as the broker is holding money market mutual fund shares for its customer, the customer has a security entitlement to the money market mutual fund shares. It is also common for brokers to offer their customers an arrangement in which the customer has access to those liquid assets via a deposit account with a bank, whereby shares of the money market fund are redeemed to cover checks drawn on the account. Article 8 applies only to the securities account; the linked bank account remains an account governed by other [non-Article 8] law."</p> <p>Certificates of deposits are an example of a form of property that may fall within the definition of "financial assets" even though they may not fall within the definition of "security." Prefatory Note III.C.9 to Article 8.</p>
Scope (9-109)	9-109(d)(13) –Article 9 does not apply to an assignment of a	9-109 does not exclude securities, securities accounts or

Topic	Deposit Account	Securities Account
	deposit account in a consumer transaction, but 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds. <sup>5</sup> <i>See also</i> OC 16 to 9-109.	security entitlements.
Choice of Law: Attachment	1-301 (former 1-105) – left to agreement of the parties, subject to generally applicable qualifications	1-301 (former 1-105) – left to agreement of the parties, subject to generally applicable qualifications
Choice of Law: Perfection, the Effect of Perfection or Nonperfection, and Priority (9-301 - 9-307)	<p>9-304(a) – The local law of a bank’s jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a deposit account maintained with that bank.</p> <p>9-304(b) provides the rules for determining a bank’s jurisdiction. 9-304(b)(1) states that “If an agreement between the bank and its customer governing the deposit account expressly provides that a particular jurisdiction is the bank’s jurisdiction for purposes of this part [Part 3 of Article 9], this article [Article 9], or [the UCC], that jurisdiction is the bank’s jurisdiction.” In the absence of such an agreement, 9-304(b)(2)-(5) provide further rules.</p> <p>OC 2 to 9-304 states that “Subsection (b)(1) permits the parties to choose the law of one jurisdiction to govern perfection and priority of security interests and a different governing law for other purposes. The parties’ choice is effective, even if the jurisdiction whose law is chosen bears no relationship to the parties or the transaction. Section 8-110(e)(1) [the analogous provision for a securities</p>	<p>9-305 – as to perfection, depends on the method of perfection (control, automatic or filing); as to priority the law of the securities intermediary’s jurisdiction</p> <p>9-305(a)(3) and (c)(1) and (2) – The local law of the securities intermediary’s jurisdiction as specified in 8-110(e) governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in a security entitlement or securities account except that the local law of the jurisdiction in which the debtor is located (9-307) governs (1) perfection of a security interest in investment property by filing and (2) automatic perfection of a security interest in investment property created by a broker or securities intermediary.</p> <p>8-110(e) provides the rules for determining the securities intermediary’s jurisdiction. 8-110(e)(1) states that “If an agreement between the securities intermediary and its entitlement holder governing the securities account expressly provides that a particular jurisdiction is the securities intermediary’s jurisdiction for purposes of this part [Part 1 of Article 8], this article [Article 8], or [this Act], that jurisdiction</p>

<sup>5</sup> Under former Article 9, deposit accounts as original collateral were excluded from the scope of Article 9 unless the account was evidenced by a certificate of deposit. Non-uniform provisions brought deposit accounts within the scope of former Article 9 in California, Illinois and several other states. Former Article 9 covered deposit accounts as proceeds. *See* former 9-104(l), former 9-105(e) (definition of deposit account); *see also* OC 4(a) to 9-101.

Topic	Deposit Account	Securities Account
	intermediary] has been conformed to subsection (b)(1) . . . .”	<p>is the securities intermediary’s jurisdiction.” In the absence of such an agreement, 8-110(e)(2)-(5) provide further rules. <i>See also</i> 8-110(f) and OCs 3 and 5 to 8-110.</p> <p>OC 3 to 8-110 – The validation of the parties’ selection of governing law by agreement is not conditioned upon a determination that the jurisdiction whose law is chose bear a “reasonable relation” to the transaction</p>
Change in Law Governing Perfection (9-316)	<p>If perfection is by control and if the bank’s jurisdiction changes, then the jurisdiction whose law governs perfection under 9-304(a) changes as well. The change will not result in an immediate loss of perfection. <i>See</i> OC 3 to 9-304 and OC 2 to 9-316.</p> <p>9-316(f) – A security interest in deposit accounts that is perfected under the law of the bank’s jurisdiction remains perfected until the earlier of (1) the time the security interest would have become unperfected under the law of that jurisdiction; or (2) the expiration of four months after a change of the applicable jurisdiction to another jurisdiction.</p> <p>9-316(g) – If a security interest described in 9-316(f) becomes perfected under the law of the other jurisdiction before the earlier of the time or the end of the period described in that subsection, it remains perfected thereafter. If the security interest does not become perfected under the law of the other jurisdiction before the earlier of that time or the end of that period, it becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value.</p>	<p>If perfection is by control and if the securities intermediary’s jurisdiction changes, then the jurisdiction whose law governs perfection under 9-305(a)(3) changes as well. Similarly, if perfection is automatic or by filing and if the debtor’s location changes, then the law governing perfection under 9-305(c)(1) and (2) changes as well. These changes will not result in an immediate loss of perfection. <i>See</i> OC 5 to 9-305 and OC 2 to 9-316.</p> <p>9-316(f) – A security interest in investment property (which includes a securities account and security entitlements) that is perfected under the law of the securities intermediary’s jurisdiction remains perfected until the earlier of (1) the time the security interest would have become unperfected under the law of that jurisdiction; or (2) the expiration of four months after a change of the applicable jurisdiction to another jurisdiction.</p> <p>9-316(g) – If a security interest described in 9-316(f) becomes perfected under the law of the other jurisdiction before the earlier of the time or the end of the period described in that subsection, it remains perfected thereafter. If the security interest does not become perfected under the law of the other jurisdiction before the earlier of that time or the end of that</p>

Topic	Deposit Account	Securities Account
		<p>period, it becomes unperfected and is deemed never to have been perfected as against a purchaser of the collateral for value.</p> <p>9-316(a) and (b) contain the analogous rules for perfection by filing and automatic perfection.</p>
Attachment	<p>General rules in 9-203 apply; control is a substitute for an authenticated record. <i>See</i> 9-203(a)-(b), OC 3 and 4 to 9-203, OC 2 to 9-104.</p>	<p>General rules in 9-203 apply; control is a substitute for an authenticated record. <i>See</i> 9-203(a)-(b), OC 3 and 4 to 9-203. There are additional rules specific to securities accounts:</p> <ul style="list-style-type: none"> <li>• 9-203(h) – Attachment of a security interest in a securities account is also attachment of a security interest in the security entitlements carried in the securities account. <i>See also</i> OC 10 to 9-203.</li> <li>• 9-206(a) and (b) provides for the automatic attachment of a security interest in favor of a securities intermediary to a person’s security entitlement if (1) the person buys a financial asset through the securities intermediary in a transaction in which the person is obligated to pay the purchase price to the securities intermediary at the time of the purchase; and (2) the securities intermediary credits the financial asset to the buyer’s securities account before the buyer pays the securities intermediary; that security interest secures the person’s obligation to pay for the financial asset. <i>See also</i> OCs 2 and 4 to 9-206.</li> </ul> <p><i>See also</i> Prefatory Note II.D to Article 8.</p>
Collateral Description (9-108)	<p>General rules apply, no additional rules specific to deposit accounts. <i>See</i> OC 16 to 9-109.</p>	<p>General rules apply; in addition there are rules specific to securities accounts and security entitlements:</p> <ul style="list-style-type: none"> <li>• 9-108(d) provides that (except as provided with respect to a consumer transaction), a description of a security entitlement or securities account is sufficient if it describes</li> </ul>

Topic	Deposit Account	Securities Account
		<p>(1) the collateral by those terms or as investment property; or (2) the underlying financial asset.</p> <ul style="list-style-type: none"> <li>9-108(e) provides that in a consumer transaction a description only by type of collateral defined in the UCC is an insufficient description of a security entitlement or securities account</li> </ul> <p><i>See also</i> OCs 4 and 5 to 9-108..</p>
Methods of Perfection	<p>Control is the only means of perfecting a security interest in a deposit account as original collateral. 9-312(b)(1), 9-314(a); <i>see also</i> OC 5 to 9-312, OC 2 to 9-104 and OC 4(d) to 9-101.</p> <p>A security interest in a deposit account as proceeds of other collateral is perfected as provided in 9-315. <i>See also</i> OCs 5 and 7 to 9-315.</p>	<p>There are three methods of perfection applicable to securities accounts as original collateral:</p> <ul style="list-style-type: none"> <li>Control (9-314(a))</li> <li>Automatic perfection (only if created by broker or securities intermediary) (9-309(10); <i>see also</i> OC 6 to 9-309)</li> <li>Filing (9-312(a))</li> </ul> <p><i>See also</i> OC 4(d) to 9-101, Prefatory Note II.D to Article 8.</p> <p>A security interest in a securities account as proceeds of other collateral is perfected as provided in 9-315. <i>See also</i> OCs 5, 6 and 7 to 9-315.<sup>6</sup></p> <p>9-308(f) – Perfection of a security interest in a securities account also perfects a security interest in the security entitlements carried in the securities account</p>
Methods of Control	<p>9-104(a) - a secured party has control of a deposit account if:<sup>7</sup></p> <ul style="list-style-type: none"> <li>(1) the secured party is the bank with which the deposit account is maintained;<sup>8</sup></li> </ul>	<p>9-106(a) – a person has control of a security entitlement as provided in 8-106</p>

<sup>6</sup> Whether the securities account is “cash proceeds” will have an effect on the period of perfection without further action. *See* “*Is the Account ‘Cash Proceeds’?*” below.

<sup>7</sup> The control methods for deposit accounts are derived from 8-106. *See* OCs 1 and 3 to 9-104.

Topic	Deposit Account	Securities Account
	<ul style="list-style-type: none"> <li>• (2) the debtor, secured party and bank have agreed in an authenticated record<sup>9</sup> 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</li> <li>• (3) the secured party becomes the bank’s customer with respect to the deposit account.<sup>10</sup></li> </ul> <p>An agreement to comply with the secured party’s instructions suffices for control of a deposit account under 9-104(a)(2) even if the bank’s agreement is subject to specified conditions (<i>e.g.</i> that the secured party’s instructions are accompanied by a certification that the debtor is in default). However, control does not exist and the security interest is not perfected if the secured party cannot direct disposition without the debtor’s consent. OC 3 to 9-104.</p>	<p>8-106(d) – A purchaser<sup>11</sup> has control of a security entitlement<sup>12</sup> if:</p> <ul style="list-style-type: none"> <li>• (1) the purchaser becomes the entitlement holder;</li> <li>• (2) the securities intermediary has agreed that it will comply with entitlement orders<sup>13</sup> originated by the purchaser without further consent by the entitlement holder;<sup>14</sup> or</li> <li>• (3) another person (other than the debtor) has control of the security entitlement on behalf of the purchaser or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the purchaser</li> </ul> <p><i>See also</i> OCs 1, 4 and 7 to 8-106.</p> <p>8-106(e) – If an interest in a security entitlement is granted by the entitlement holder to the entitlement holder’s own securities intermediary, the securities intermediary has control (<i>e.g.</i> margin loan by broker). <i>See</i> OC 6 to 8-106.</p>

<sup>8</sup> The bank that maintains the deposit account has automatic perfection; no other form of public notice is necessary and all actual or 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. OC 3 to 9-104.

<sup>9</sup> A control agreement for a deposit account must be in an authenticated record, while a control agreement for a securities account only requires that the securities intermediary have agreed to comply with entitlement orders of the secured party. *Compare* 9-104(a)(2) with 8-106(d)(2); *see* OC 3 to 9-104. The terms “authenticate” and “record” are defined in 9-102(a)(7) and (69).

<sup>10</sup> Customer is defined in 4-104. *See* 9-102(b). As the customer, the secured party would enjoy the right to withdraw funds from, or close, the deposit account. *See* OC 3 to 9-104.

<sup>11</sup> Purchaser is defined in 1-201(b)(29) and (30) (former 1-201(32) and (33)) to include a secured party.

<sup>12</sup> For drafting convenience, control with respect to a securities account is defined in terms of obtaining control over the security entitlements. An agreement that provides that (without further consent of the debtor) the securities intermediary will honor instruction from the secured party concerning a securities account described as such is sufficient; such an agreement necessarily implies that the intermediary will honor instructions concerning all security entitlements carried in the account and thus affords the secured party control of all the security entitlements. OC 4 to 9-106. Similarly, OC 4 to 8-106 states that control arrangement might cover all of the positions in a particular account or subaccount or only specified positions. *See also* OC 6 to 9-102.

<sup>13</sup> An entitlement order is defined in 8-102(a)(8) as “ a notification communicated to a securities intermediary directing transfer or redemption of a financial asset to which the entitlement holder has a security entitlement.”

<sup>14</sup> OC 5 to 8-106 states that a power of attorney from the debtor to the secured party is not control (the intermediary must be a party to the agreement).

Topic	Deposit Account	Securities Account
	<p>Article 9 makes a distinction between control and a blocked account – while the arrangements giving rise to control may themselves prevent, or may enable the secured party at its discretion to prevent, the debtor from reaching the funds on deposit, (i) 9-104(b) and OC 3 to 9-104 make clear that the debtor’s ability to reach the funds is not inconsistent with control and (ii) 9-104(a)(2) makes clear that having only a blocked account is not sufficient for the secured party to have control.</p>	<p>8-106(f) – A purchaser that has satisfied the requirements of subsection (d) has control, even if the entitlement holder retains the right to make substitutions for the security entitlement, to originate entitlement orders to the securities intermediary or otherwise to deal with the security entitlement. <i>See also</i> OC 7 to 8-106.</p>
Control through Third Party Acting for Secured Party	<p>Not specifically recognized – rely on application of supplemental principles (such as agency) which are applicable as provided in 1-103(b) (former 1-103)</p>	<p>Specifically recognized in 8-106(d)(3) (provided that the person cannot be the debtor)</p>
Termination of Perfection by Control	<p>A security interest in a deposit account as original collateral is perfected when the secured party obtains control and remains perfected by control as long as the secured party retains control. 9-314(a) and (b).</p>	<p>A security interest in a security entitlement is perfected when the secured party obtains control and remains perfected by control until the secured party no longer has control and the debtor is or becomes the entitlement holder. 9-314(a) and (c). This rule for security entitlements is intended to accommodate repledges by the secured party. <i>See</i> OC 3 to 9-314 and OC 5 to 9-207.</p> <p><i>See also</i> OC 4(d) to 9-101.</p>
Is the Account “Cash Proceeds” (9-102(a)(9))?	<p>“Cash proceeds” means proceeds that are money, checks, deposit accounts, or the like.</p> <p><i>Cash proceeds are sometimes treated differently from other proceed, e.g.:</i></p> <ul style="list-style-type: none"> <li>• 9-315(d)(2) – perfection of security interest in identifiable cash proceeds continues indefinitely</li> </ul>	<p>The phrase “or the like” in the definition of cash proceeds covers property that is “functionally equivalent to ‘money, checks, or deposit account,’ such as some money market accounts that are securities or part of security entitlements.” OC 13(e) to 9-102.</p>



Topic	Deposit Account	Securities Account
	<ul style="list-style-type: none"> <li>• 9-315(d)(1) – effect on continued perfection of proceeds acquired with cash proceeds</li> <li>• 9-322(c) – priority rules and proceeds</li> <li>• 9-324 (a) and (b) -- PMSI priority generally does not continue in proceeds of inventory, but does continue in cash proceeds received on or before delivery of the inventory to the buyer (contrast with equipment PMSI)</li> </ul>	
Priority	<p>9-327 established the following priorities among conflicting security interests in a deposit account:<sup>15</sup></p> <ol style="list-style-type: none"> <li>1. A secured party that has control of the deposit account has priority over a secured party that does not have control (e.g. a secured party that has control of a deposit account has priority over a party claiming a security interest in the deposit account as identifiable cash proceeds of other collateral under 9-315). <i>See</i> OC 3 to 9-327.</li> <li>2. Except as otherwise provided in paragraphs (3) and (4) below, where more than one security interest is perfected by control, priority ranks according to time of obtaining control. <i>See</i> OC 3 to 9-327.</li> <li>3. Except as otherwise provided in paragraph (4) below, a security interest held by the bank with which the deposit account is maintained (which automatically has control under 9-104(a)(1))<sup>16</sup> has priority over a conflicting security interest held by another secured party. The bank that maintains the deposit account will have priority over competing security interests (regardless of whether the</li> </ol>	<p>9-328 establishes the following priorities among conflicting security interests in a securities account and security entitlements:</p> <ul style="list-style-type: none"> <li>• 9-328(1) – A security interest held by a secured party having control of the securities account or security entitlements under 9-106 has priority over a security interest held by a secured party that that does not have control of the securities account or security entitlements</li> <li>• 9-328(2) -- Except as otherwise provided in paragraph (3) conflicting security interests held by secured parties each of which has control under 9-106 rank according to priority in time of: <ul style="list-style-type: none"> <li>(i) if the secured party obtained control by becoming the entitlement holder (8-106(d)(1)), the secured party’s becoming the person for which the securities account is maintained,</li> <li>(ii) if the secured party obtained control Through a control agreement (8-106(d)(2)), the securities intermediary’s agreement to comply with the secured party’s entitlement orders with respect to security</li> </ul> </li> </ul>

<sup>15</sup> 9-327 overrides conflicting priority rules. OC 2 to 9-327.

<sup>16</sup> *See* “*Methods of Control*” above.

Topic	Deposit Account	Securities Account
	<p>deposit account is original collateral or proceeds of other collateral of the competing secured party). <i>See</i> OC 4 to 9-327.</p> <p>4. A security interest perfected by the secured party’s becoming the customer of the depository bank (<i>i.e.</i> under 9-104(a)(3)) has priority over a security interest held by the bank with which the deposit account is maintained. <i>See</i> OC 4 to 9-327.</p> <p><i>See also</i> OC 4(e) to 9-101.</p> <p><b>Practice notes:</b> These priority provisions affect the terms of deposit account control agreements – the depository bank is generally asked to (i) represent that it has not entered into other control agreements, and (ii) waive or subordinate its priority rights, and the terms of such waiver and subordination are usually the subject of negotiation. <i>See</i> 9-339 and OC 2 to 9-339 (subordination by agreement).</p> <p>The priority provided by 9-327 does not extend to proceeds of a deposit account, and 9-322(c) through (e) and the provisions referred to in 9-322(f) govern priorities in such proceeds. <i>See</i> 9-322, OCs 6-9 to 9-322 and OC 5 to 9-327. <i>See also</i> 9-324(a) and (b) as to continuation of PMSI priority in proceeds. 9-315(d) addresses the continuation of perfection in such proceeds.</p> <p><i>See also</i> “<i>Intermediary Rights</i>” below.</p>	<p>entitlements carried or to be carried in the securities account, or</p> <p>(iii) if the secured party obtained control through another person under 8-106(d)(3), the time on which the priority would be based under this paragraph if the other person were the secured party</p> <ul style="list-style-type: none"> <li>• 9-328(3) – 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</li> <li>• 9-328(6) – Conflicting security interests created by a broker or securities intermediary that are perfected without control under 9-106 rank equally</li> <li>• 9-328(7) – In all other cases, priority among conflicting security interests is governed by 9-322 (general “first to file or otherwise perfect” rule) and 9-323 (general rule as to priorities with respect to future advances)</li> </ul> <p><i>See also</i> OC 4(e) to 9-101.</p> <p><b>Practice notes:</b> These priority provisions affect the terms of securities account control agreements – the securities intermediary is generally asked to (i) represent that it has not entered into other control agreements, and (ii) waive or subordinate its priority rights, and the terms of such waiver and subordination are usually the subject of negotiation. <i>See</i> 9-339 and OC 2 to 9-339 (subordination by agreement).</p> <p>[equivalent to OC 5 to 9-327?]</p>

Topic	Deposit Account	Securities Account
		8-511(b) – Priority of securities intermediary’s secured party over rights of the entitlement holder
“Takes Free” Rules	<p>Deposit account itself generally is not transferred.</p> <p>Any transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee is acting in collusion with the debtor in violating the rights of the secured party. 9-332(b) and OCs to 9-332.</p> <p>9-332(a) provides a comparable rule for money (including currency withdrawn from a deposit account).</p>	<p>Securities account itself generally is not transferred.</p> <p>Security entitlements also are generally not transferred, because the “sale” terminates the existing entitlement and creates a new entitlement. A security interest in an entitlement would be one case of a transfer of an interest in an entitlement. See OC 5 to 8-501.</p> <p>Purchasers of securities may be protected as “protected purchasers” under 8-303; parties that acquire security entitlements have analogous protections under 8-502, 8-503(e) and 8-510. For 8-502, the elements are (i) giving of value and (ii) lack of notice of adverse claim; for 8-503(e), the elements are (i) giving of value, (ii) obtaining control, and (iii) not acting in collusion; for 8-510 the elements are (i) giving of value, (ii) lack of notice of adverse claim, and (iii) obtaining control. See also 8-511 and OC 4 to 9-331.</p> <p>Shelter principal applies to subsequent transferees. 8-302(a), 8-510(b).</p> <p>No specific provision dealing with a transferee of funds from a securities account.</p>

Topic	Deposit Account	Securities Account
Intermediary Rights	<p>9-340 establishes the relative priority<sup>17</sup> of a depository bank’s rights of set-off and recoupment<sup>18</sup> against a deposit account and a security interest in the account:</p> <ol style="list-style-type: none"> <li>1. Except as otherwise provided in paragraph (3) below, a bank with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party that holds a security interest in the deposit account. <i>See</i> OC 2 to 9-340.</li> <li>2. Except as otherwise provided in paragraph (3) below, the application of Article 9 to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained by the secured party. A bank may hold both a right of set-off and a security interest in the same deposit account, and by holding a security interest in a deposit account a bank does not impair any right of set-off it would otherwise have. <i>See</i> OC 3 to 9-340.</li> <li>3. A bank may not effect a set-off against a deposit account where a secured party controls the deposit account because it is the bank’s customer with respect to the</li> </ol>	No comparable provision to 9-340 located.

<sup>17</sup> 9-340 deals with rights of set-off and recoupment that a bank may have under other (non-Article 9) law; it does not create a right of set-off or recoupment, nor is it intended to override any limitations or restrictions that other law imposes on the exercise of those rights. *See* OC 2 to 9-340.

<sup>18</sup> Black’s Law Dictionary (6th Edition) defines “**recoupment**” as:

A right of the defendant to have a deduction from the amount of the plaintiff’s damages, for the reason that the plaintiff has not complied with the cross-obligations or independent covenants arising under the same contract. It implies that plaintiff has cause of action, but asserts that defendant has counter cause of action growing out of breach of some other part of same contract on which plaintiff’s action is founded, or for some cause connected with contract. [case citations omitted]

A “set-off” is a demand which the defendant has against the plaintiff, arising out of a transaction extrinsic to the plaintiff’s cause of action, whereas a “recoupment” is a reduction or rebate by the defendant of part of the plaintiff’s claim because of a right in the defendant arising out of the same transaction. [case citations omitted]

Topic	Deposit Account	Securities Account
	<p>deposit account, if the set-off is based on a claim against the debtor. The bank may exercise its recoupment rights. <i>See</i> OC 2 to 9-340.</p> <p><b>Practice notes:</b> These priority provisions affect the terms of deposit account control agreements – the bank is generally asked to waive or subordinate its rights, and the terms of such waiver and subordination are usually the subject of negotiation on matters such as fees, overdrafts and returned items. <i>See</i> 9-339 and OC 2 to 9-339 (subordination by agreement).</p>	
Intermediary Obligations (and Limits on Obligations)	<p>9-341<sup>19</sup> provides that (except as otherwise provided in 9-340(c)),<sup>20</sup> unless the bank otherwise agrees in an authenticated record, a bank’s rights and duties with respect to a deposit account maintained with the bank are not terminated, suspended or modified by:</p> <ul style="list-style-type: none"> <li>• the creation, attachment or perfection of a security interest in the deposit account,</li> <li>• the bank’s knowledge of the security interest, or</li> <li>• the bank’s receipt of instructions from the secured party.</li> </ul> <p>Article 9 does not require a bank to enter into a control agreement, even if its customer so requests or directs, and 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. <i>See</i> 9-342 and OC 2 to 9-342.</p>	<p>[no comparable provision to 9-341 located]</p> <p>8-106(g) – A securities intermediary:</p> <ul style="list-style-type: none"> <li>• may not enter into a control agreement without the consent of the entitlement holder</li> <li>• is not required to enter into such an agreement even though the entitlement holder so directs</li> <li>• is not required, if it has entered into such an agreement, to confirm the existence of the agreement to another party unless requested to do so by the entitlement holder</li> </ul> <p>8-507(a) -- a securities intermediary shall comply with an entitlement order if the entitlement order is originated by the appropriate person, the securities intermediary has had reasonable opportunity to assure itself that the entitlement order is genuine and authorized and the securities intermediary has</p>

<sup>19</sup> *See* OCs to 9-341.

<sup>20</sup> As described above (*see* “*Intermediary Rights*”), 9-340(c) limits a bank’s right of set-off (but not its right of recoupment) if the secured party becomes the bank’s customer with respect to the account.

Topic	Deposit Account	Securities Account
		had reasonable opportunity to comply with the entitlement order
Secured Party Remedies	<p>9-607(a)(4) and (5) provide that if so agreed, and in any event after default, a secured party:</p> <ul style="list-style-type: none"> <li>• that holds a security interest in a deposit account perfected under 9-104(a)(1) (<i>i.e.</i> the secured party is the bank where the account is maintained) may apply the balance of the deposit account to the secured obligation</li> <li>• that holds a security interest in a deposit account perfected by control under 9-104(a)(2) or (3) (<i>i.e.</i> pursuant to a control agreement or the secured party's becoming the bank's customer with respect to the account) may instruct the bank to pay the balance of the deposit account to or for the benefit of the secured party</li> </ul> <p>If a security interest in a deposit account is not perfected by control (<i>e.g.</i> is unperfected or is perfected by virtue of the proceeds rules in 9-315), the depository institution ordinarily owes no obligation to obey the secured party's instructions. In such circumstances, to reach the funds without the debtor's cooperation the secured party must use an available judicial procedure. <i>See</i> 9-341 and 9-607(e), OC 7 to 9-607 and OC 4(i) to 9-101.</p> <p><b>Practice notes:</b> The security agreement should specify that certain actions (<i>e.g.</i> incurring a penalty for early withdrawal of a time deposit) are commercially reasonable actions by the secured party.</p>	<p>9-607 does not include provisions specific to a securities account. 9-607(a) generally provides that if so agreed, and in any event after default, a secured party may (1) notify an account debtor or other person obligated on collateral to make payment or otherwise render performance to or for the benefit of the secured party; (2) take any proceeds to which the secured party is entitled under 9-315; and (3) may enforce the obligations of an account debtor or other person obligated on collateral and exercise the rights of the debtor with respect to the obligation of the account debtor or other person obligated on collateral to make payment or otherwise render performance to the debtor.</p> <p>If a security interest in a securities account is not perfected by control (<i>e.g.</i> is unperfected, is perfected by filing or is perfected by virtue of the proceeds rules in 9-315), the securities intermediary ordinarily owes no obligation to obey the secured party's instructions. In such circumstances, to reach the funds without the debtor's cooperation the secured party must use an available judicial procedure. <i>See</i> OC 3 to 8-507; 9-607(e) and OC 6 to 9-607.</p> <p>Unlike a deposit account (where the secured party can apply the funds to the debt), if the secured party obtains the property in a securities account it must then follow the applicable rules under Part 6 of Article 9 to dispose of or collect on the collateral.</p> <p><b>Practice notes:</b> Security agreement should specify that certain actions (<i>e.g.</i> selling securities without registration in order to</p>

Topic	Deposit Account	Securities Account
		comply with securities laws) are commercially reasonable actions by the secured party.
Secured Party Rights and Duties	<p>9-601(b) provides that a secured party in control of collateral under 9-104 has the rights and duties provided in 9-207. <i>See also</i> OC 4 to 9-601.</p> <p>9-207(c) identifies the following duties and rights of a secured party having control of a deposit account under 9-104 (unless the parties have otherwise agreed):<sup>21</sup></p> <ul style="list-style-type: none"> <li>• the secured party may hold as additional security any proceeds, except money or funds, received from the collateral,</li> <li>• the secured party shall apply money or funds received from the collateral to reduce the secured obligations, unless remitted to the debtor, and</li> <li>• the secured party may create a security interest in the collateral.</li> </ul> <p><i>See also</i> OCs 4 and 5 to 9-207.</p> <p>9-208(a) and (b)(1) and (2) provides that if there is no outstanding secured obligation and the secured party is not committed to make advances, incur obligations or otherwise give value, within 10 days after receiving an authenticated demand from the debtor a secured party with control of a deposit account will, as applicable, terminate the control agreement or release the balance in the account to the debtor.</p>	<p>9-601(b) provides that a secured party in control of collateral under 9-106 (securities accounts and security entitlements) has the rights and duties provided in 9-207. <i>See also</i> OC 4 to 9-601.</p> <p>9-207(c) identifies the following duties and rights of a secured party having control of security entitlements under 9-106 (unless the parties have otherwise agreed):<sup>22</sup></p> <ul style="list-style-type: none"> <li>• the secured party may hold as additional security any proceeds, except money or funds, received from the collateral,</li> <li>• the secured party shall apply money or funds received from the collateral to reduce the secured obligations, unless remitted to the debtor, and</li> <li>• the secured party may create a security interest in the collateral.</li> </ul> <p><i>See also</i> OCs 4 and 5 to 9-207. OC 6 to 9-207 contains a discussion of repledge of investment property (<i>i.e.</i> a security entitlement); there is no comparable discussion of repledge of a deposit account or funds in a deposit account.</p> <p>9-208(a) and (b)(4) provides that if there is no outstanding secured obligation and the secured party is not committed to make advances, incur obligations or otherwise give value, within 10 days after receiving an authenticated demand from</p>

<sup>21</sup> *See* OC 3 to 9-207.

<sup>22</sup> *See* OC 3 to 9-207.

Topic	Deposit Account	Securities Account
	<p>If the secured party fails to comply with 9-208, the debtor has the remedies provided in 9-625(e). <i>See</i> OC 3 to 9-208.</p> <p>The secured party's duties under 9-208 can be varied by agreement of the parties. <i>See</i> OC 2 to 9-208.</p>	<p>the debtor a secured party with control of a security entitlement pursuant to a control agreement will terminate control. There is no specific provision in 9-208 dealing with a secured party that has obtained control by becoming the entitlement holder; OC 4 to 9-208 (discussing common law obligation to relinquish possession of collateral) would probably apply by analogy.</p> <p>If the secured party fails to comply with 9-208, the debtor has the remedies provided in 9-625(e). <i>See</i> OC 3 to 9-208.</p> <p>The secured party's duties under 9-208 can be varied by agreement of the parties. <i>See</i> OC 2 to 9-208.</p>
Direct Payment Rights and Negation of Restrictions on Assignment (9-404, 9-405, 9-406, 9-408)	Not applicable. Whether a debtor's rights in such collateral may be voluntarily or involuntarily transferred is governed solely by law other than Article 9. <i>See</i> 9-401.	Not applicable. Whether a debtor's rights in such collateral may be voluntarily or involuntarily transferred is governed solely by law other than Article 9. <i>See</i> 9-401.
Nonuniformities	<i>See</i> Penelope Christophorou, Kenneth Kettering, Lynn Soukup & Steven Weise, <i>Under the Surface of Revised Article 9: Selected Variations in State Enactments from the Official Text of Revised Article 9</i> , 34 UCC L.J. 331 (2002)	<i>See</i> Penelope Christophorou, Kenneth Kettering, Lynn Soukup & Steven Weise, <i>Under the Surface of Revised Article 9: Selected Variations in State Enactments from the Official Text of Revised Article 9</i> , 34 UCC L.J. 331 (2002)



ABA Business Law Section  
Spring Meeting 2003

Even If You Are A Real Estate/ Securities/Corporate/Partnership/  
Emerging Company/Finance Lawyer:  
What Every Lawyer Needs to Know About UCC Article 8

Friday, April 4, 2003

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A Model  
"Account Control Agreement"  
under Revised Article 9 of the  
Uniform Commercial Code

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*February 2003*

## Model Account Control Agreement

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### Introduction

In many secured transactions, the debtor may wish to use a securities account as collateral while retaining the right to buy and sell securities in the account. Since 1994, Article 9 of the Uniform Commercial Code has provided specific mechanisms for perfecting security interests in securities accounts. One of these mechanisms is the *account control agreement*.

An account control agreement ordinarily does not *grant* a security interest in a securities account; that is the job of the security agreement between the debtor and the creditor. Rather, an account control agreement is a three-party agreement between the debtor, the creditor and the debtor's securities intermediary that *perfects* the security interest created by the security agreement.

There are other ways under Article 9 for a secured creditor to perfect a securities interest in a securities account. It could perfect by filing a financing statement indicating the securities account as collateral, or it could have the property in the debtor's securities account transferred to its own securities account. But a security interest perfected by an account control agreement will be prior to a security interest perfected by filing, and could prove less complicated than having the secured creditor open its own securities account.

Under the pre-1994 version of Articles 8 and 9, brokerage firms entered into tri-party "pledged account" agreements that perfected the creditor's interest by mov-

ing securities to a special pledge account for which the brokerage customer had trading privileges. The statutory mechanisms introduced in 1994 enabled debtors, secured creditors and brokerage houses to place these practices on a firmer footing.

The model agreement that follows uses the Article 8 and 9 provisions to perfect a debtor's security interest in a securities account, but it also borrows from pre-1994 pledged account agreements, particularly as to indemnity and exculpation. The model is presented twice – first by itself and then with commentary tracing the provisions back to their origins in Articles 8 and 9 or in existing pledged account agreement practice. The commentary assumes familiarity with the approach and terminology of Articles 8 and 9.

The model is directed at legal concerns – it is designed to perfect a security interest in a brokerage account in the most direct way possible. The term "model" is not meant to preclude modifications that address business concerns.

We have tried to keep the model simple. Since account control agreements will be used for retail customers, this seemed appropriate, although the provisions should also work for institutional investors. We were also concerned that the model agreement not confuse non-lawyers, such as brokerage house operations personnel, not familiar with UCC terminology. The model is not, however, a "plain English" document – we felt free

to use legal terminology such as "indemnify," "joint and several" and "security interest."

An earlier version of this article appeared in the November 1997 issue of *The Business Lawyer*. In 2001, we revised the article to take account of the 1998 revisions to Articles 8 and 9 (*revised Article 9*). This latest version has been slightly revised to take account of some additional

practical and theoretical concerns that have arisen under revised Article 9.

Except as otherwise noted, section references in the commentary are to the Uniform Commercial Code as amended by revised Article 9.

*Howard Darmstadter*  
*Sandra M. Rocks*  
*Steven O. Weise*

## ACCOUNT CONTROL AGREEMENT

[date]

### PARTIES

- First National Bank (*Creditor*)
- Amy Borrower (*Customer*)
- Street Wise & Co. (*Broker*)

### BACKGROUND

Customer has granted Creditor a security interest in a securities account maintained by Broker for Customer. The parties are entering into this agreement to perfect Creditor's security interest in that account.

### AGREEMENT

#### 1 The Account

Broker represents and warrants to Creditor that:

- Broker maintains securities account number 1234-5678 for Customer (together with any securities account maintained by Broker described in section 10, "Successor Accounts" below, the *Account*).
- Exhibit A is a statement produced by Broker in the ordinary course of its business regarding the property credited to the Account at the statement's date. Broker does not know of any inaccuracy in the statement.
- Broker does not know of any claim to or interest in the Account, except for claims and interests of the parties referred to in this agreement [, *except* that property noted as [...] or [...] on Exhibit A is not property in the Account].

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 [jurisdiction] Uniform Commercial Code.

#### 2 Control by Creditor

Broker will comply with all notifications it receives directing it to transfer or redeem any financial assets in the Account (each an *entitlement order*) originated by Creditor without further consent by Customer.

#### 3 Customer's rights in Account

Except as otherwise provided in this section 3, Broker will comply with entitlement orders originated by Customer without further consent by Creditor.

If Creditor notifies Broker that Creditor will exercise exclusive control over the Account (a *notice of exclusive control*), Broker will cease:

- complying with entitlement orders or other directions concerning the Account originated by Customer, and
- distributing to Customer interest and dividends on financial assets in the Account.

Until Broker receives a notice of exclusive control, Broker may distribute to Customer all interest and regular cash dividends on financial assets in the Account.

Broker will not comply with any entitlement order originated by Customer that would require Broker to make a free delivery of any financial assets in the Account to Customer or any other person.

#### 4 Priority of Creditor's security interest

Broker subordinates in favor of Creditor any security interest, lien or right of setoff Broker may have, now or in the future, against the Account or financial assets in the Account, *except* that Broker will retain its prior lien on financial assets in the Account to secure payment for financial assets purchased for the Account and normal commissions and fees for the Account.

#### 5 No third party control

Broker represents and warrants that no third party has a right to give an entitlement order regarding financial assets in the Account.

Broker will not agree with any third party that Broker will comply with entitlement orders originated by the third party.

#### 6 Statements, confirmations and notices of adverse claims

Broker will send copies of all statements and confirmations for the Account simultaneously to Customer and Creditor.

Broker will use reasonable efforts promptly to notify Creditor and Customer if any other person claims that it has a property interest in a financial asset in

the Account and that it is a violation of that person's rights for anyone else to hold, transfer or deal with the financial asset.

#### **7 Broker's responsibility**

Except for permitting a withdrawal, delivery or payment in violation of section 3, Broker will not be liable to Creditor for complying with entitlement orders from Customer that are received by Broker before Broker receives and has a reasonable opportunity to act on a notice of exclusive control.

Broker will not be liable to Customer for complying with a notice of exclusive control or with entitlement orders originated by Creditor, even if Customer notifies Broker that Creditor is not legally entitled to issue the entitlement order or notice of exclusive control, unless:

- Broker takes the action after it is served with an injunction, restraining order or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had a reasonable opportunity to act on the injunction, restraining order or other legal process, or
- Broker acts in collusion with Creditor in violating Customer's rights.

This agreement does not create any obligation of Broker except for those expressly set forth in this agreement. In particular, Broker need not investigate whether Creditor is entitled under Creditor's agreements with Customer to give an entitlement order or a notice of exclusive control. Broker may rely on notices and communications it believes given by the appropriate party.

#### **8 Indemnity**

Creditor and Customer will indemnify Broker, its officers, directors, employees and agents against claims, liabilities and expenses arising out of this agreement (including reasonable attorneys' fees and disbursements), except to the extent the claims, liabilities or expenses are caused by Broker's gross negligence or willful misconduct. Creditor's and Customer's liability under this section is joint and several.

#### **9 Termination; survival**

Creditor may terminate this agreement by notice to Broker and Customer. Broker may terminate this agreement on 30 days' notice to Creditor and Customer.

If Creditor notifies Broker that Creditor's security interest in the Account has terminated, this agreement will immediately terminate.

Sections 7, "Broker's responsibility," and 8, "indemnity," will survive termination of this agreement.

#### **10 Successor Accounts**

The Account will include the securities account described in section 1, any substitute or replacement securities account, and any securities account maintained by Broker into which property from the Account is transferred, unless the Creditor expressly agrees in writing prior to the transfer that the account into which such property is transferred will not be subject to this agreement.

#### **11 Governing law**

This agreement will be governed by the laws of the State of [jurisdiction].

#### **12 Entire agreement; amendments**

This agreement is the entire agreement, and supersedes any prior agreements and contemporaneous oral agreements, of the parties concerning its subject matter.

No amendment of, or waiver of a right under, this agreement will be binding unless it is in writing and signed by the party to be charged.

#### **13 Severability**

To the extent a provision of this agreement is unenforceable, this agreement will be construed as if the unenforceable provision were omitted.

#### **14 Successors and assigns**

A successor to or assignee of Creditor's rights and obligations under the security agreement between Creditor and Customer will succeed to Creditor's rights and obligations under this agreement.

#### **15 Notices**

A notice or other communication to a party under this agreement will be in writing (except that enti-

tlement orders may be given orally), will be sent to the party's address set forth below or to such other address as the party may notify the other parties and will be effective on receipt.

SIGNATURES

ADDRESSES

CUSTOMER

\_\_\_\_\_  
Amy Borrower

CREDITOR

First National Bank

By \_\_\_\_\_

BROKER

Street Wise & Co.

By \_\_\_\_\_

ACCOUNT CONTROL AGREEMENT

[date]

## PARTIES

- **First National Bank** (*Creditor*)
- **Amy Borrower** (*Customer*)
- **Street Wise & Co.** (*Broker*)

## BACKGROUND

Customer has granted Creditor a security interest in a securities account maintained by Broker for Customer. The parties are entering into this agreement to perfect Creditor's security interest in that account.

"Account control agreement," while descriptive, is not a term used in Articles 8 and 9.

An account control agreement is voluntary. Broker is not required to enter into the agreement even if Customer so directs, and cannot enter into such an agreement without Customer's consent. §8-106(g). For Creditor to have "control," Broker must be a party to the agreement. §8-106, official comment 5. (The importance of "control" is explained below.)

An account control agreement will not ordinarily include a security agreement. Creditor and Customer will enter into a separate agreement granting the security interest. Broker will usually not want to be involved in that part of the transaction.

## AGREEMENT

**1 The Account**

Broker represents and warrants to Creditor that:

- Broker maintains securities account number 1234-5678 for Customer (together with any securities account maintained by Broker described in section 10, "Successor Accounts" below, the *Account*).
  
- Exhibit A is a statement produced by Broker in the ordinary course of its business regarding the property credited to the Account at the statement's date. Broker does not know of any inaccuracy in the statement.

This identifies the securities account and establishes that Customer has rights in it.

A "securities account" is "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account [here, Broker] undertakes to treat the person for whom the account is maintained [Customer] as entitled to exercise the rights that comprise the financial asset." §8-501(a). "Account" is obviously not used in the definition of securities account (or in the model agreement) in its Article 9 sense of a right to payment of certain monetary obligations. §9-102(a)(2).

Broker does not represent or warrant the accuracy of the account statement, only that it was produced in the ordinary course of business and that Broker does not know that the statement is inaccurate. Broker "knows" of an inaccuracy if it has actual knowledge of the inaccuracy. §1-201(25). Knowledge by Broker is effective for transactions subject to the account control agreement when it is brought to the attention of the individual(s) conducting the transaction. §1-201(27).



- Broker does not know of any claim to or interest in the Account, except for claims and interests of the parties referred to in this agreement [, *except* that property noted as [...] or [...] on Exhibit A is not property in the Account].

Broker's representation and warranty will provide Creditor with some comfort that Customer has a "clean" title to the financial assets in the Account. For example, it will provide comfort that the Account is not a joint account. (Sections 4, "priority of creditor's security interest," and 5, "no third party control," will give Creditor comfort as to the priority of its security interest.)

Financial assets registered in Customer's name, payable to her order or specially endorsed to her (and that have not been endorsed to Broker or in blank) are not part of the Account. §8-501(d). Therefore, Creditor can not perfect its security interest in such assets by using an account control agreement. To avoid listing any such assets, Broker may want to set up a separate "clean" account that does not contain such assets. Alternatively, Broker may include the bracketed language identifying those assets that may be listed in the account statement but are not part of the Account. (Some brokers mark these assets as "certificated" or "in safekeeping.")

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 [jurisdiction] Uniform Commercial Code.

This paragraph assures that Creditor will have a perfected security interest in all property in the Account, even if the property is not a security. "Financial assets" include (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 Account if Broker agrees that the property is to be treated as a financial asset under Article 8. § 8-102(a)(9).

Once the property in the Account is a "financial asset," Customer will have a "security entitlement" with respect to it (§8-102(a)(17)). Customer's security entitlement with respect to a financial asset will be "investment property" under revised Article 9, and Creditor will be able to perfect a security interest in such investment property by an account control agreement, as described in the commentary to section 2 below.

A commodity contract can not be a "financial asset." §8-103(f). Accordingly, Customer can not have a security entitlement with respect to a commodity contract. Commodity contracts and commodity accounts are investment property (§9-102) in which a security interest can be perfected by control conferred by an appropriate agreement between a commodity intermediary, its customer and a secured creditor (§9-106(b)(2)). However, the model agreement presented here would have to be reworked before it would be adequate to perfect such a security interest.

## 2 Control by Creditor

Broker will comply with all notifications it receives directing it to transfer or redeem any financial assets in the Account (each an *entitlement order*) originated by Creditor without further consent by Customer.

This provision perfects Creditor's security interest in both the Account and the financial assets in the Account.

A securities account, such as the Account, and the security entitlements carried in the Account, are all "investment property." §9-102(a)(49). Creditor may therefore perfect its security interest in the Account and the securities entitlements by "control." §9-314(a). A security interest perfected by control has priority over a security interest not perfected by control, such as a security interest perfected by filing. §9-328(1).

Creditor will have control over the security entitlements carried in the Account if Broker agrees to comply with entitlement orders originated by Creditor without further consent by Customer. §§9-106(a), 8-106(d)(2). (An "entitlement order" is a notice to Broker directing it to transfer or redeem a financial asset to which Customer has a security entitlement. §8-102(a)(8).) An agreement that provides that Broker will, without Customer's consent, honor instructions from Creditor concerning the Account will give Creditor control over the security entitlements carried in the Account. §9-106, official comment 4.

If Creditor obtains control over all security entitlements carried in the Account, Creditor will also have control over the Account (§ 9-106(c)), and therefore will have perfected its security interest in the Account (§ 9-314(a)).

Under the account control agreement, Creditor's right to give an entitlement order is not conditioned on Customer's default under any agreement between Customer and Creditor. If Creditor's right to give an entitlement order was conditioned on Customer's default, it would still be "control." § 8-106, official comment 7. It is not likely, however, that Broker will want to be put in the position of having to decide whether the condition has been satisfied – that is, whether Creditor has become entitled to give an entitlement order.

### 3 Customer's rights in Account

Except as otherwise provided in this section 3, Broker will comply with entitlement orders originated by Customer without further consent by Creditor.

In the absence of other agreement, Broker has a duty to comply with Customer's entitlement orders. § 8-507(a). The importance of this sentence lies, therefore, in its introductory proviso. Customer's right to give entitlement orders does not preclude Creditor from having control over the Account. § 8-106(f).

Creditor might want to limit the kinds of investment that Customer can make. Such a provision would, however, require a degree of monitoring that Broker may be unable or unwilling to provide.

## Model Account Control Agreement

## Commentary

If Creditor notifies Broker that Creditor will exercise exclusive control over the Account (a *notice of exclusive control*), Broker will cease:

- complying with entitlement orders or other directions concerning the Account originated by Customer, and
- distributing to Customer interest and dividends on financial assets in the Account.

Until Broker receives a notice of exclusive control, Broker may distribute to Customer all interest and regular cash dividends on financial assets in the Account.

Broker will not comply with any entitlement order originated by Customer that would require Broker to make a free delivery of any financial assets in the Account to Customer or any other person.

Broker's duty to obey Customer's entitlement orders can be modified by agreement. § 8-507, comment 3. If Creditor can not cut off Customer's right to give entitlement orders, Customer could try to countermand Creditor's entitlement orders.

The security agreement should state the circumstances under which Creditor can deliver a notice of exclusive control. If the Account is not to be used for trading by Customer, Creditor may provide in the security agreement that a notice of exclusive control will be given at inception.

"Notice of exclusive control" is not a term used in revised Article 9.

Customer's right to receive dividends and other distributions does not defeat Creditor's control. § 8-106, official comment 4, example 7.

Creditor will have control without this provision. However, allowing Customer to withdraw property or make free deliveries from the Account would undermine the value of Creditor's security interest. If Creditor wants to allow Customer to make a specific withdrawal or free delivery, Creditor can give the appropriate entitlement order. A more complicated alternative would be for the account control agreement to allow Customer to give the entitlement order if Creditor gives Broker a certificate permitting the withdrawal or delivery.

#### 4 Priority of Creditor's security interest

Broker subordinates in favor of Creditor any security interest, lien or right of setoff Broker may have, now or in the future, against the Account or financial assets in the Account, *except* that Broker will retain its prior lien on financial assets in the Account to secure payment for financial assets purchased for the Account and normal commissions and fees for the Account.

#### 5 No third party control

Broker represents and warrants that no third party has a right to give an entitlement order regarding financial assets in the Account.

This section and the following section 5 give Creditor priority over any other security interests in the Account that are perfected by control.

Without this subordination, Broker would have priority over Creditor. §9-328(3). A consequence of Broker's subordination is that the Account must be a cash account, not a margin account. Broker's junior security interest may be useful to Broker if Customer has a debit in a separate margin account with Broker.

If a third party could give such an order without Customer's further consent, the third party would have "control." §8-106(d)(2). If it also had a security interest in property in the Account, that security interest would be prior to Creditor's. §9-328(2)(B)(ii). Even if the third party did not have a security interest, it could transfer property out of the Account, which could destroy perfection of Creditor's security interest.

Broker will not agree with any third party that Broker will comply with entitlement orders originated by the third party.

#### **6 Statements, confirmations and notices of adverse claims**

Broker will send copies of all statements and confirmations for the Account simultaneously to Customer and Creditor:

Broker will use reasonable efforts promptly to notify Creditor and Customer if any other person claims that it has a property interest in a financial asset in the Account and that it is a violation of that person's rights for anyone else to hold, transfer or deal with the financial asset.

Broker has represented (preceding sentence) that no third party has the right to give entitlement orders. If Broker and Customer subsequently enter into an account control agreement with a third party, Creditor's security interest will be prior to the third party's security interest. § 9-328(2)(B)(ii). Nonetheless, Creditor will still want to prevent any third party acquiring the right to transfer property out of the Account.

This will assist Creditor in monitoring the Account.

The claims referred to in this sentence are "adverse claims." § 8-102(a)(1).

## 7 Broker's responsibility

Except for permitting a withdrawal, delivery or payment in violation of section 3, Broker will not be liable to Creditor for complying with entitlement orders from Customer that are received by Broker before Broker receives and has a reasonable opportunity to act on a notice of exclusive control.

Broker will not be liable to Customer for complying with a notice of exclusive control or with entitlement orders originated by Creditor, even if Customer notifies Broker that Creditor is not legally entitled to issue the entitlement order or notice of exclusive control, unless:

- Broker takes the action after it is served with an injunction, restraining order or other legal process enjoining it from doing so, issued by a court of competent jurisdiction, and had a reasonable opportunity to act on the injunction, restraining order or other legal process, or
- Broker acts in collusion with Creditor in violating Customer's rights.

This paragraph treats Creditor's delivery of a notice of exclusive control like an adverse claimant's obtaining of an injunction or other legal process. Under revised Article 9, if Broker transfers a financial asset pursuant to an effective entitlement order, Broker is not liable to an adverse claimant unless Broker "took the action after being served with an injunction, restraining order or other legal process enjoining it from doing so ... and had a reasonable opportunity to act on the injunction, restraining order or legal process." §8-115(1).

If Customer gives such notice, it is an adverse claimant. §8-102(a)(1). The sentence states the rule of section 8-115, as preserved by section 9-331(b).



This agreement does not create any obligation of Broker except for those expressly set forth in this agreement. In particular, Broker need not investigate whether Creditor is entitled under Creditor's agreements with Customer to give an entitlement order or a notice of exclusive control. Broker may rely on notices and communications it believes given by the appropriate party.

#### **8 Indemnity**

Creditor and Customer will indemnify Broker, its officers, directors, employees and agents against claims, liabilities and expenses arising out of this agreement (including reasonable attorneys' fees and disbursements), except to the extent the claims, liabilities or expenses are caused by Broker's gross negligence or willful misconduct.

Creditor's and Customer's liability under this section is joint and several.

Broker is not likely to charge a fee for entering into an account control agreement but may do so as an accommodation to Customer. Broker will therefore not want to take additional material risks, and will want to be indemnified against claims.

Joint and several liability of Customer and Creditor on the indemnity is common, though not universal, in pledged account agreements governed by pre-1994 Article 9.

## 9 Termination; survival

Creditor may terminate this agreement by notice to Broker and Customer. Broker may terminate this agreement on 30 days' notice to Creditor and Customer.

If Creditor notifies Broker that Creditor's security interest in the Account has terminated, this agreement will immediately terminate.

Sections 7, "Broker's responsibility," and 8, "indemnity," will survive termination of this agreement.

Broker should have the right to terminate the account control agreement or the Account. However, simply permitting Broker to terminate the control arrangement would pose too great a risk to Creditor unless Creditor has enough time to move the collateral to another account subject to Creditor's perfected security interest. The steps Creditor can take in this situation should be set out in the security agreement.

## 10 Successor Accounts

The Account will include the securities account described in section 1, any substitute or replacement securities account, and any securities account maintained by Broker into which property from the Account is transferred, unless the Creditor expressly agrees in writing prior to the transfer that the account into which such property is transferred will not be subject to this agreement.

## 11 Governing law

This agreement will be governed by the laws of the State of [jurisdiction].

A brokerage accounts may be renumbered for operational reasons. For example, part of the account number may designate the branch at which the account is maintained, so that if the account is moved to a different branch, or if the branch number is changed, the account number will automatically change.

An account may also be changed from an account in a single name to a joint account, or vice-versa, or a trust account may be transferred to the trust's beneficiary. This section makes all these renumbered or transferee accounts subject to the control agreement.

There may, of course, be a question as to whether the control agreement will be effective to bind, for example, a trust beneficiary when only the trustee signed the control agreement. These issues may be handled in the security agreement or other agreements. This section merely provides that the transfer, in itself, will not render the control agreement ineffective.

Perfection and priority of Creditor's security interest will be governed by the local law of Broker's "jurisdiction." §9-305(a)(3). The local law of Broker's jurisdiction also governs issues concerning the indirect holding system that are

dealt with in Article 8. §8-110(b); official comment 3.

If an agreement between Broker and Customer specifies a particular jurisdiction as Broker's jurisdiction, that is Broker's jurisdiction for purposes of revised Article 9. §§9-305(a)(3), 8-110(e)(1). Such a specification would most likely appear in the agreement between Broker and Customer that governs the Account. If so, it would prevail over the governing law specification in the model account control agreement. If, however, there is no agreement between Customer and Broker governing the Account (as frequently happens for cash accounts), or if the agreement does not specify Broker's jurisdiction, then the governing law specification in the model agreement will be effective to specify Broker's jurisdiction. §8-110(e)(2).

The jurisdiction specified in the agreement need not bear a "reasonable relation" to the transaction. §8-110, official comment 3.

Revised Article 9 has been adopted in every state, as have the 1994 revisions to Article 8.

## 12 Entire agreement; amendments

This agreement is the entire agreement, and supersedes any prior agreements and contemporaneous oral agreements, of the parties concerning its subject matter.

No amendment of, or waiver of a right under, this agreement will be binding unless it is in writing and signed by the party to be charged.

### 13 Severability

To the extent a provision of this agreement is unenforceable, this agreement will be construed as if the unenforceable provision were omitted.

### 14 Successors and assigns

A successor to or assignee of Creditor's rights and obligations under the security agreement between Creditor and Customer will succeed to Creditor's rights and obligations under this agreement.

### 15 Notices

A notice or other communication to a party under this agreement will be in writing (except that entitlement orders may be given orally), will be sent to the party's address set forth below or to such other address as the party may notify the other parties and will be effective on receipt.

Creditor will probably prefer to lose any particular provision rather than have the entire agreement voided and perfection of its security interest lost.

Without this sentence, an assignee of Creditor's security interest would have to obtain Customer's and Broker's agreement to a new account control agreement if it wished to retain perfection by control.

Model Account Control Agreement

Commentary

SIGNATURES

ADDRESSES

CUSTOMER

\_\_\_\_\_  
Amy Borrower

CREDITOR

First National Bank

By \_\_\_\_\_

BROKER

Street Wise & Co.

By \_\_\_\_\_

Investment Securities Subcommittee (UCC Committee) 2003 ABA Annual Meeting

**CONTROL AGREEMENT REGARDING UNCERTIFICATED SECURITIES**

**ISSUER CONTROL AGREEMENT** dated as of *[date]* among \_\_\_\_\_ (“Pledgor”), \_\_\_\_\_ (“Secured Party”), and \_\_\_\_\_ (“Issuer”). All references herein to the “UCC” are to the Uniform Commercial Code as in effect from time to time in the State of New York.

Pledgor is the registered holder of *[describe securities]* issued by Issuer (the “Securities”).

Pursuant to a Security Agreement dated as of *[date]* (as amended or supplemented from time to time, “Security Agreement”), Pledgor has granted to Secured Party a security interest (“Security Interest”) in all right, title and interest of Pledgor in, to and under the Securities, whether now existing or hereafter arising.

The parties hereto are entering into this Agreement in order to perfect the Security Interest in the Securities.

**IN CONSIDERATION OF THE FOREGOING** and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto agree as follows:

**1. Nature of Securities.** Issuer confirms that (i) the Securities are “uncertificated securities” (as defined in Section 8-102 of the UCC and of the Uniform Commercial Code as in effect in *[state of organization of Issuer]*) and (ii) Pledgor is registered on the books of Issuer as the registered holder of the Securities.

**2. Instructions.** Issuer agrees to comply with any “instruction” (as defined in Section 8-102 of the UCC) originated by Secured Party and relating to the Securities without further consent by Pledgor or any other person. Pledgor consents to the foregoing agreement by Issuer.

**3. Waiver of Lien; Waiver of Set-off.** Issuer waives any security interest, lien or right of setoff that it may now have or hereafter acquire in or with respect to the Securities. Issuer’s obligations in respect of the Securities will not be subject to deduction, setoff or any other right in favor of any person other than Secured Party.

**4. Conflict with Other Agreements.** There is no agreement (except this Agreement and *[list other relevant documents, if any]*) between Issuer and Pledgor with respect to the Securities. In the event of any conflict between this Agreement (or any portion hereof) and any other agreement between Issuer and Pledgor with respect to the Securities, whether now existing or hereafter entered into, the terms of this Agreement shall prevail.

**5. Notice of Adverse Claims.** Except for the claims and interests of Secured Party and Pledgor in the Securities, Issuer does not know of any claim to, or interest in, the Securities. If any person asserts any lien, encumbrance or adverse claim (including any writ, garnishment, judgment, attachment, execution or similar process) against the Securities, Issuer will promptly notify Secured Party and Pledgor thereof.

**6. Maintenance of Securities.** In addition to, and not in lieu of, the obligation of Issuer to honor instructions as agreed in **Section 2** hereof, Issuer agrees as follows:

(i) *Pledgor Instructions; Notice of Exclusive Control.* So long as Issuer has not received a Notice of Exclusive Control (as defined below), Issuer shall comply with instructions of Pledgor or any duly authorized agent of Pledgor in respect of the Securities. After Issuer receives a written notice from Secured Party that Secured Party is exercising exclusive control over the Securities (a "**Notice of Exclusive Control**"), Issuer will cease complying with instructions of Pledgor or any of its agents.

(ii) *Non-Cash Dividends and Distributions.* After Issuer receives a Notice of Exclusive Control, Issuer shall deliver to Secured Party all dividends, interest and other distributions paid or made upon or with respect to the Securities.

(iii) *Voting Rights.* Until Issuer receives a Notice of Exclusive Control, Pledgor shall be entitled to direct Issuer with respect to voting the Securities.

(iv) *Statements and Confirmations.* Issuer will promptly send copies of all statements and other correspondence concerning the Securities simultaneously to each of Pledgor and Secured Party at their respective addresses specified in **Section 9** hereof.

(v) *Tax Reporting.* All items of income, gain, expense and loss in respect of the Securities shall be reported to any and all applicable taxing authorities under the name and taxpayer identification number of Pledgor.

**7. Representations, Warranties and Covenants of Issuer.** Issuer makes the following representations, warranties and covenants:

(i) This Agreement is a valid and binding agreement of Issuer enforceable in accordance with its terms.

(ii) Issuer has not entered into, and until the termination of this Agreement will not without the consent of Secured Party enter into, any agreement with any other person relating to the Securities pursuant to which it has agreed, or will agree, to comply with instructions (as defined in Section 8-102 of the UCC) of such person. Issuer has not entered into any other agreement with Pledgor or Secured Party purporting to limit or condition the obligation of Issuer to comply with instructions as agreed herein.

**8. Successors.** This Agreement shall be binding upon, and shall inure to the benefit of, the parties hereto and their respective successors and assigns.

**9. Notices.** Each notice, request or other communication given to any party hereunder shall be in writing (including facsimile or other electronic transmission) and shall be effective (i) when delivered to such party at its address specified below, (ii) when sent to such party by facsimile or other electronic transmission, addressed to it at its facsimile number or electronic address specified below, or (iii) five days after being sent to such party by certified or registered United States mail, addressed to it at its address specified below, with first class or airmail postage prepaid:

**Pledgor:**



**Secured Party:**

**Issuer:**

Any party may change its address, facsimile number and/or e-mail address for purposes of this **Section 9** by giving notice of such change to the other parties in the manner specified above.

**10. Amendments; Termination.** No amendment or modification of this Agreement or waiver of any right hereunder shall be binding on any party hereto unless it is in writing and is signed by all the parties hereto. The rights and powers granted herein to Secured Party (i) have been granted in order to perfect the Security Interest, (ii) are powers coupled with an interest, and (iii) will not be affected by any bankruptcy of Pledgor or any lapse of time. The obligations of Issuer hereunder shall continue in effect until Secured Party has notified Issuer in writing that the Security Interest has been terminated pursuant to the Security Agreement.

**11. Counterparts.** This Agreement may be executed in any number of counterparts, all of which shall constitute one and the same instrument, and any party hereto may execute this Agreement by signing and delivering one or more counterparts.

**13. Choice of Law.** This Agreement shall be governed by the laws of the State of New York (without giving effect to any choice of law provisions thereof that would result in the application of the laws of another jurisdiction).

**IN WITNESS WHEREOF**, the parties hereto have caused this Agreement to be duly executed as of the day and year first above written.

**Pledgor**

By: \_\_\_\_\_

Name:

Title:

**Secured Party**

By: \_\_\_\_\_

Name:

Title:

**Issuer**

By: \_\_\_\_\_

Name:

Title:

**[If signed by Transfer Agent]**

Accepted and agreed by:

[NAME OF ISSUER]

By: [NAME OF TRANSFER AGENT] ("**Transfer Agent**")

By: \_\_\_\_\_

Name:

Title:

The Transfer Agent hereby represents and warrants to Secured Party and Pledgor that it has full capacity and authority to execute this Agreement as agent for and on behalf of Issuer in a manner sufficient to provide Secured Party with "control" of the Securities within the meaning of Section 8-106(c)(2) of the UCC.

[NAME OF TRANSFER AGENT]

By: \_\_\_\_\_

Name:

Title:

## **EQUITY INTERESTS AS COLLATERAL**

***Lynn A. Soukup***  
***Pillsbury Winthrop Shaw Pittman LLP***

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A prior version of this outline is included in the course materials for the January 12, 2011 PLI course  
*Secured Transactions 2011: What Lawyers Need to Know about UCC Article 9*

## TABLE OF CONTENTS

I.	INTRODUCTION — WHAT’S IN A NAME (OR FOR UCC PURPOSES, A TYPE OF COLLATERAL)? .....	1
II.	COLLATERAL TYPE AND CATEGORY .....	2
	A.    UCC Type .....	2
	B.    Categories of Investment Property .....	4
III.	OPTING IN TO ARTICLE 8 .....	5
	A.    Requirements for Opt In .....	5
	B.    Additional Actions .....	6
IV.	CREATION OF SECURITY INTEREST .....	7
	A.    General .....	7
	B.    Delivery or Control as Substitute for Authenticated Record .....	9
V.	PERFECTION OF SECURITY INTEREST .....	9
	A.    General Intangibles .....	10
	B.    Certificated Security .....	10
	C.    Uncertificated Security .....	11
	D.    Security Entitlements/Securities Account .....	12
VI.	BENEFITS OF AN OPT IN UNDER ARTICLE 8 .....	13
	A.    “Protected Purchaser” Status for Secured Party with Respect to Certificated and Uncertificated Securities .....	13
	B.    Priority if Perfect by Control or Delivery .....	14
	C.    Flexibility in Method of Perfection .....	15
VII.	BENEFITS OF CERTIFICATED SECURITIES UNDER ARTICLE 8 .....	16
	A.    Ability to Obtain Exclusive Control .....	16
	B.    Means of Obtaining Control May be Easier to Put Into Effect .....	16
	C.    Protection Against Subsequent Purchasers and Other Persons .....	17
VIII.	RESTRICTIONS ON ASSIGNMENT AND THE EFFECT OF OPTING IN .....	17
	A.    Alienability of Debtor’s Rights Generally .....	17
	B.    Restrictions on Transfer of a Security (Article 8) .....	18
	C.    Article 9 Negation of Anti-Assignment Provisions Not Applicable to Securities .....	19
IX.	RISKS TO THE SECURED PARTY OF REQUIRING A CERTIFICATED INTEREST .....	22

A.	Dilution Upon Issuance of Replacement Certificate .....	22
B.	Loss of Perfection .....	22
C.	Secured Party Standard of Care in Custody of Certificate .....	23
D.	Controlling Distributions .....	24
E.	Reliance on Compliance by Debtor and Issuer .....	25
X.	LEGAL OPINIONS .....	25
A.	General .....	25
B.	Creation .....	25
C.	Perfection .....	26
D.	Priority and Protected Purchaser Status .....	27
XI.	UCC INSURANCE .....	28
A.	Lender Requirement .....	28
B.	Insurer Requirements .....	28
XII.	FORECLOSURE .....	29
A.	Disposition of Collateral and Secured Party Purchase .....	29
B.	Cases .....	31
C.	Securities Law Considerations .....	34

## **EXHIBITS**

**Exhibit A** – Sample Irrevocable Proxy Relating to Article 8 Matters

**Exhibit B** – Sample Security Agreement Language Relating to Disposition of Collateral and Securities Laws Matters

**Exhibit C** – Further Discussion of *Burns v. Anderson*

**Exhibit D** – Opt In and Proceeds under Former Articles 8 and 9

**Exhibit E** – Methods of Perfection

**Exhibit F** – Choice of Law Analysis – Perfection

**Exhibit G** – Choice of Law Analysis – Priority

**Exhibit H** – Negation of Restrictions on Assignment

## EQUITY INTERESTS AS COLLATERAL

*Lynn A. Soukup*

### I. INTRODUCTION — WHAT’S IN A NAME (OR FOR UCC PURPOSES, A TYPE OF COLLATERAL)?

Equity interests – including corporate stock, partnership interests and interests in a limited liability company (“**LLC**”) – are common collateral in commercial loan transactions. In real estate mezzanine loans equity interests are the primary – if not the only – collateral.

Equity interests as collateral may present a number of unique planning and documentation issues, including:

- Determining the provisions of the Uniform Commercial Code (the “**UCC**”)<sup>1</sup> that may – or may not – be applicable depending on the type of entity that is the issuer of the pledged equity interest and other specific facts relating to the pledged interest
- Steps the secured party can require that change the provisions of the UCC that will apply to the pledged equity interest
- Variations in the UCC as enacted in the applicable state(s)<sup>2</sup>
- Terms of the entity governing documents and the applicable entity statute (*e.g.* state partnership or LLC statute)
- Federal and state securities laws that may affect the exercise of a secured party’s remedies.

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<sup>1</sup> References to the “**UCC**,” “**Article 1**,” “**Article 8**” or “**Article 9**” are to the 2009-2010 Official Text and Comments thereto, unless otherwise specified. References to Sections are to the cited Sections of the UCC unless otherwise specified. Unless otherwise specified, references to “**Former Article 9**” or “**Former Section 9-xxx**” are to the Official Text of Article 9 of the UCC as in effect prior to the revisions that were effective on July 1, 2001 (or later in a small number of states), references to “**Former Article 8**” or “**Former Section 8-xxx**” are to the Official Text of Article 8 of the UCC as in effect prior to the 1994 revisions thereto, and references to “**Former Article 1**” or “**Former Section 1-xxx**” are to the Official Text of Article 1 of the UCC as in effect prior to the 2001 revisions thereto.

State variations from the current and former versions of the Official Text of the UCC, as well as state specific comments (such as those in New York) are generally not addressed in these materials, and the text of the UCC (including comments) in the relevant jurisdiction(s) should be reviewed. In addition, in a transaction with contacts with jurisdictions other than the United States (*e.g.* the pledge of an interest in a non-U.S. entity) the laws of the applicable non-U.S. jurisdiction(s) should also be considered.

<sup>2</sup> Section 9-102(a)(76) of the UCC defines “**state**” as “a State of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.”

These considerations affect a lender's diligence prior to accepting an equity interest as collateral, the documentation of its security interest, steps taken to perfect the security interest, the priority of the security interest, whether the lender is protected against other parties' claims to the pledged equity interests and the remedies that the lender may pursue (and requirements it may be required to meet to exercise those remedies) and rights it can obtain following a default.

## II. COLLATERAL TYPE AND CATEGORY

### A. UCC Type

A rose by any other name may smell as sweet,<sup>3</sup> but the UCC collateral "type" applicable to an LLC, general partnership or limited partnership interest, corporate stock or other equity interest has significant implications.

While corporate stock, an interest in a statutory or business trust or a similar equity interest is a security for purposes of Article 9 of the UCC,<sup>4</sup> generally an LLC or partnership interest will be a general intangible for purposes of Articles 8 and 9, and not a security,<sup>5</sup> other investment

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<sup>3</sup> See William Shakespeare, *Romeo and Juliet* (Act II, scene 2).

<sup>4</sup> See Sections 8-102(a)(15) (definition of "security," incorporated into Article 9 by Section 9-102(b)), 8-103(a) ("A share or similar equity interest issued by a corporation, business trust, joint stock company or similar entity is a security."). See also Official Comment 2 to Section 8-103 ("Subsection [8-103](a) establishes an unconditional rule that ordinary corporate stock is a security. That is so whether or not the particular issue is dealt in or traded on securities exchanges or in securities markets. Thus, shares of closely held corporations are Article 8 securities."). A few cases have held that stock in specialized entities is not a security. See, e.g., *In re Turley*, 172 F.3d 671 (6<sup>th</sup> Cir. 1999) (stock related to ownership of franchise in auto racing event organization was a general intangible and not an Article 8 security).

<sup>5</sup> See Section 8-102(a)(15) (definition of "security," incorporated into Article 9 by Section 9-102(b)); Official Comment 15 to Section 8-102; Section 8-103; Official Comment 4 to Section 8-103.

Section 8-103 provides rules for determining whether certain obligations and interests are securities, including that (1) a share or similar equity interest issued by a corporation, business trust, joint stock company or similar entity is a security, and (2) an interest in a partnership or limited liability company is not a security unless (i) it is dealt in or traded on securities exchanges or in securities markets, (ii) its terms expressly provide that it is a security governed by Article 8, or (iii) it is an investment company security (*i.e.* a share or similar equity interest issued by an entity that is registered as an investment company under the federal investment company laws (the Investment Company Act of 1940, as amended), an interest in a unit investment trust that is so registered or a face-amount certificate issued by a face-amount certificate company that is so registered). See *In re Dreiling*, 2007 WL 172364, 61 UCC Rep. Serv. 2d 837 (Bankr. W.D. Mo. 2007) (debtor's interest in an LLC was a general intangible, not a security; no evidence presented that LLC interest was traded on an exchange or in a securities market, that LLC was an investment company, that LLC agreement provided that the interest was a security under the opt-in provision of Section 8-103 or that interest was held in a securities account); *In re Weiss*, 376 B.R. 867 (Bankr. N.D. Ill. 2007) (LLC and limited partnership interests usually considered general intangibles under Article 9).

property<sup>6</sup> or other type of collateral.<sup>7</sup> However, Article 8 provides a mechanism – referred to as “opting in” – for bringing LLC and partnership interests within the definition of security<sup>8</sup> and obtaining a number of benefits for the secured party.<sup>9</sup>

The UCC collateral type applicable to an item of collateral affects a number of issues under Article 9 as well as the applicability of Article 8:

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<sup>6</sup> “**Investment property**” includes a security (whether a certificated security or an uncertificated security), a security entitlement and a securities account, as well as a commodity contract or commodities account. Section 9-102(a)(49).

While it is not common for an LLC or partnership interest to be held in a securities account, if such an interest were held as a financial asset in a securities account the interest would be a security entitlement (and therefore investment property) for purposes of Articles 8 and 9. *See* Sections 8-102(a)(9) (defining “financial asset” to include any property a securities intermediary has agreed to treat as a financial asset), 8-501 (acquisition of security entitlement occurs through crediting of financial asset to customer’s account). *See also* Howard Darmstadter, A Brief Historical Introduction to Article 8, included in the materials for the ABA Business Law Section Spring 2003 Meeting program *Even If You are a Real Estate / Securities / Corporate / Partnership / Emerging Company / Finance Lawyer: What Every Lawyer Needs to Know About UCC Article 8* (April 4, 2003) (available from [lynn.soukup@pillsburylaw.com](mailto:lynn.soukup@pillsburylaw.com) and included in materials for ABA Center for Continuing Legal Education program *What Every Lawyer Needs to Know About UCC Article 8* (June 25, 2003).

<sup>7</sup> While an argument can be made that an LLC or partnership interest that is certificated but is not a security for purposes of Articles 8 and 9 of the UCC is an instrument (defined in Section 9-102(a)(47) to include any “writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease, and is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment”), the better reasoning is that such an interest is a general intangible. Prudence would indicate, however, that a secured party take possession of any existing LLC or partnership interest certificate (and take steps to prevent pledged interests from being certificated post-closing). In addition even if the certificated LLC or partnership interest is a general intangible (so that perfection of the security interest cannot be effected by possession of the certificate) possession may be helpful (or necessary) to effect transfers in connection with an exercise of remedies or for other purposes not related to perfection of the security interest.

<sup>8</sup> Section 8-103(c); Official Comment 4 to Section 8-103; Section III(C)(8) of the Prefatory Note to Article 8. *See generally* L. Soukup, *It’s a Matter of Collateral: LLCs, Partnerships and the UCC*, 14 *Business Law Today* 53 (Jan./Feb. 2005).

The process for opting in to Article 8 is discussed in Part III below and the potential benefits for the secured party as discussed in Parts VI and VII below. Other considerations relating to opting in are discussed in Parts VIII and IX, as well as more generally throughout this article.

While Section 8-103(c) is worded differently from Sections 8-103(a) and (b), the effect is intended to be the same – an LLC or partnership interest for which an opt in to Article 8 has been effected is a security.

As discussed in notes 5 and 6 *supra*, there are other circumstances in which an LLC or partnership interest will be classified as a security or other investment property, but those do not commonly occur and are not applicable in common types of financing involving LLC or partnership interests as collateral, such as real estate mezzanine financing.

<sup>9</sup> A historical reason for an “opt in” under prior law that is no longer applicable under the current version of Article 9 is discussed in **Exhibit D**.



- Requirements applicable to attachment of a security interest, including collateral description
- Perfection methods (and related choice of law)
- Priority (and related choice of law)
- Applicability of the negation of anti-assignment provisions in Part 4 of Article 9
- Ability of the secured party to obtain better rights to the collateral than the debtor<sup>10</sup> has through “protected purchase,” “takes free” and similar provisions (and related choice of law)
- Appropriate legal opinions

## **B. Categories of Investment Property**

For purpose of Articles 8 and 9, securities may be either “**certificated securities**” (evidenced by a certificate under applicable non-UCC law) or “**uncertificated securities**” (book-entry on the records of the issuer or its transfer agent).<sup>11</sup>

A “**security entitlement**” refers to the rights of a party that holds an interest in a security or other property through the indirect holding system (*i.e.* where one or more intermediaries, such as a broker or bank or DTC or another clearing corporation, exists between the issuer of the security and the ultimate beneficial owner of the security).<sup>12</sup> A “**securities account**” is essentially a collection of security entitlements.<sup>13</sup>

The applicable category of investment property will be relevant to issues such as (i) collateral descriptions, (ii) perfection methods and related choice of law, and (iii) priority and protected purchaser or other takes free or similar rules and related choice of law.

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<sup>10</sup> “**Debtor**” as used in this context is the party with an interest in the collateral (*i.e.* the owner of or holder of other rights in the property), which need not be the obligor on the secured obligation. *See* Section 9-102(a)(28) (definition of debtor); *compare* Section 9-102(a)(59) (definition of obligor)

<sup>11</sup> *See* Section 8-102(a)(4), (15) and (18) and Official Comments 4, 15 and 18 to Section 8-102.

<sup>12</sup> *See* Section 8-102(a)(17) and Official Comment 17 to UCC Section 8-102. The rights of an entitlement holder are described in Part 5 of Article 8. A security entitlement, held in the indirect holding system, is different from an uncertificated security, held in the direct holding system.

<sup>13</sup> *See* Section 8-501(a) (definition of securities account)

### III. OPTING IN TO ARTICLE 8

#### A. Requirements for Opt In

Section 8-103(c) states that (with limited exceptions)<sup>14</sup> an LLC or partnership interest is not a security unless “its terms expressly provide that it is a security governed by this Article.” The term “opt in” comes from Official Comment 4 to Section 8-103, which states that (i) Section 8-103(c) establishes the general rule that LLC and partnership interests are not securities unless they are in fact dealt in or traded on securities exchanges or in securities markets, and (ii) the issuer<sup>15</sup> of the security, however, may explicitly “opt in” by specifying that the interests or shares are securities governed by Article 8.<sup>16</sup>

To effect an opt in, the LLC agreement or partnership agreement will need to include language specifying that the LLC or partnership interest is a security governed by Article 8.<sup>17</sup> It is possible to opt in for some but not all of the same class (or similar classes) of interests, since Section 8-103(c) states that in order for a partnership or LLC interest to be a security for purposes of Article 8 the terms of “an interest” in an LLC or partnership are to provide that the interest is a security governed by Article 8.<sup>18</sup>

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<sup>14</sup> See note 5 *supra*.

<sup>15</sup> “**Issuer**” is defined in Section 8-201; the definition of issuer generally parallels the definition of security in Section 8-102(a)(15). See Official Comment 1 to Section 8-201.

<sup>16</sup> See also Section III(C)(8) of the Prefatory Note to Article 8, which contains similar language.

<sup>17</sup> One common formulation of the opt-in language reads:

Each interest in the [issuer] shall constitute and shall remain a “security” within the meaning of (i) Section 8-102(a)(15) of the Uniform Commercial Code as in effect from time to time in the State of [state of organization of the issuer] [cite to UCC in the applicable state] (the “UCC”) and (ii) the Uniform Commercial Code of any other applicable jurisdiction that now or hereafter substantially includes the 1994 revisions to Article 8 thereof as adopted by the American Law Institute and the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association on February 14, 1995, and the [issuer] has, pursuant to the [list relevant organizational documents of the issuer] (collectively, the “Agreement”), “opted in” to such provisions for the purpose of the Uniform Commercial Code. Notwithstanding any provision of this Agreement to the contrary, to the extent that any provision of this Agreement is inconsistent with any non-waivable provision of Article 8 of the UCC, such provision of Article 8 of the UCC shall be controlling.

<sup>18</sup> The LLC or partnership laws in the relevant state should be reviewed to confirm that the LLC or partnership agreement (and not other documents, or in the case of a certificated security, the certificate) establish the terms of the interest.

The UCC also provided some guidance as to what constitutes the terms of a security. With respect to a certificated security, Section 8-202(a) provides that the terms of a certificated security include terms stated on the certificate and terms made part of the certificate by reference on the certificate. See Section 8-202(a) (provides that (i) even against a purchaser for value and without notice, the terms of a certificated security include terms stated on the certificate and terms made part of the security by reference on the certificate to another instrument, indenture or document and (ii) the terms of an uncertificated security include those stated in any instrument, indenture or document pursuant to which the security is issued).

In the case of an LLC or partnership interest represented by a certificate, the certificate also may (and in practice often does) refer to the opt in and may also refer to other matters relating to the security interest (such as noting the existence of the security interest in the security represented by the certificate and restrictions on further encumbrances).<sup>19</sup> Noting such information on the certificate may provide some additional protection to the secured party as discussed in Part VII.C below.<sup>20</sup>

## **B. Additional Actions**

If an opt in has been effected (and the secured party is relying on the benefits of the opt in and the characterization of the LLC or partnership interest as a security)<sup>21</sup> then steps should be taken to prevent the issuer of the interest from taking subsequent actions to “opt out” and return the interest to being treated as a general intangible.<sup>22</sup> These steps include:

- A proxy from the debtor to the secured party to vote the interest with respect to an amendment to the partnership or LLC agreement to alter the opt in.<sup>23</sup>
- Amendment of the LLC or partnership agreement to provide that no amendment of the opt in may be effected without the consent of the secured party.<sup>24</sup>

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<sup>19</sup> See note 18 *supra* regarding whether the opt in language should appear on the certificate.

<sup>20</sup> See Part VIII.B below regarding noting transfer restrictions on certificated securities in order for the restrictions to be effective against certain parties.

<sup>21</sup> If the issuer opts in when the secured party did not plan to have securities as collateral, a transferee of the interest from the debtor could have priority over (in the case of a secured party) or take free of (in the case of a buyer) the secured party’s security interest. See Parts V and VI.A below.

<sup>22</sup> In addition, steps should be taken to prevent the modification of the relevant provisions of the LLC or partnership agreement. In Delaware, for example, this may require taking steps so that the agreement cannot be modified through a merger. See Evangelos Kostoulas, *The Doctrine of Independent Legal Significance Applies to Alternative Entities: Some Thoughts for Lenders*, June 2010 Commercial Law Newsletter pp. 14-16 (Joint Newsletter of the Commercial Finance and UCC Committees of the Business Law Section of the American Bar Association) available at <http://www.abanet.org/buslaw/committees/CL190000pub/newsletter/201006/201006.pdf> or <http://www.youngconaway.com/files/Publication/497b9e99-c1d5-43af-ae15-2f00d3d38667/Presentation/PublicationAttachment/ed6ab90e-14ce-449c-9e0b-312a4012073d/CommNewsletter.pdf>

<sup>23</sup> An example of such a proxy is provided in **Exhibit A**; for a specific transaction the language should be tailored to the specific interest and any applicable state laws (including those limiting the use, duration or effectiveness of proxies).

<sup>24</sup> Section 18-302(3) of the Delaware Limited Liability Act specifically recognizes the consent rights of a person other than a member if provided for in the LLC agreement, stating that “[i]f a limited liability company agreement provides for the manner in which it may be amended, including by requiring the approval of a person who is not a party to the limited liability company agreement or the satisfaction of conditions, it may be amended only in that manner or as otherwise permitted by law (provided that the approval of any person may be waived by such person and that any such conditions may be waived by all persons for whose benefit such conditions were intended).” Section 17-302(f) of the Delaware

- Obtaining the agreement of the issuer of the interest not to amend the opt in without the consent of the secured party.<sup>25</sup>

A secured party should also take similar steps to maintain the certificated or uncertificated nature of the interest it has taken as collateral.<sup>26</sup>

#### IV. CREATION OF SECURITY INTEREST

##### A. General

“Attachment” of a security interest means that the conditions to its enforceability against the debtor have been satisfied. Section 9-203 generally requires that the following elements be met for the attachment of a security interest:<sup>27</sup>

- a. Value has been given.
  - For this purpose value is broadly defined and includes any consideration sufficient to support a simple contract, as well as past consideration (*i.e.* a pre-existing debt is sufficient value for the subsequent attachment of a security interest for purposes of Article 9).<sup>28</sup>
- b. The debtor has rights in the collateral or the power to transfer rights in the collateral to the secured party.

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Revised Uniform Limited Partnership Act contains a comparable provision with respect to limited partnerships and Section 15-407(e) of the Delaware Revised Uniform Partnership Act contains a comparable provision applicable to general partnerships.

<sup>25</sup> The issuer’s breach of its obligations to the secured party may put the secured party in a better position (as a creditor of the issuer with respect to damages caused by the breach) than it would be as the holder of collateral consisting of an equity interest in the issuer.

<sup>26</sup> For example if a secured party has perfected by control (through possession) of a certificated security, and the LLC or partnership agreement is amended so that the interest is no longer represented by the certificate, the perfection and priority of the security interest may be adversely affected. A similar issue could arise with respect to corporate stock or other interests that as a matter of state entity law can be either certificated or uncertificated, depending on the effect of changing from one “format” to the other as a matter of the state entity law.

<sup>27</sup> See Section 9-203(a)-(b) and Official Comment 2 to Section 9-203.

Section 9-203 refers to the attachment of a security interest, while Section 9-102(a)(73) defines a security agreement as an agreement that “creates or provides for a security interest.” The possible technical differences in the use of the terms “attachment” and “creation” is discussed in Special Report of the TriBar Opinion Committee: U.C.C. Security Interest Opinions – Revised Article 9, 58 BUS. LAW. 1449, 1463 (August 2003) (hereinafter *TriBar Revised Article 9 Report*).

<sup>28</sup> “Value” as used in Section 9-203 is defined in Section 1-204 (Former Section 1-201(44)); see Section 9-102(c) (Article 1 terms used in Article 9). Value may be assessed differently in the context of preferential transfer claims under Section 547 of the Bankruptcy Code and fraudulent conveyance claims under Section 548 of the Bankruptcy Code or applicable state law.

- The secured party may acquire better rights in the collateral than the debtor has if the secured party qualifies as a “protected purchaser” of a security, or under the free of claims and similar rules applicable to a security entitlement, as described in Part VI.A below.<sup>29</sup>

c. The debtor has authenticated<sup>30</sup> a security agreement<sup>31</sup> that provides a description of the collateral.

- In the case of a certificated security and certain other investment property, there are substitutes for an authenticated record of the security agreement, as described in Part IV.B below.
- If the collateral description<sup>32</sup> uses a UCC collateral type (*e.g.* general intangible or security) rather than a functional description (*e.g.* “LLC interest”) an opt in (or opt out) can affect whether the description identifies the collateral.<sup>33</sup>

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<sup>29</sup> See also *TriBar Revised Article 9 Report*, note 27 *supra*, at 1468 (a security interest in collateral in some circumstances is not limited to the debtor’s rights in the collateral to the extent described in Section 8-303 (dealing with protected purchasers of securities) and other specified sections of the UCC).

<sup>30</sup> Section 9-102(a)(7) defines “**authenticate**” to include both a signature and its electronic equivalent.

<sup>31</sup> Section 9-102(a)(73) defines “**security agreement**” as an agreement that creates or provides for a security interest. The terms “**agreement**” and “**security interest**” are defined in Article 1. See Section 1-201(b)(3) and (35) (Former Section 1-201(3) and (37)), Section 9-102(c) (Article 1 definitions used in Article 9).

<sup>32</sup> The rules for a legally adequate collateral description in a security agreement are found in Section 9-108. Generally a description of collateral is sufficient whether or not it is specific if it reasonably identifies what is described. Examples of reasonable identification generally include a “type” of collateral defined in the UCC (such as investment property, security or general intangible).

<sup>33</sup> The interpretation of the collateral description in a security agreement is a matter of contract interpretation. See Official Comment 3 to Section 9-703. The use of an incorrect collateral type could create potential arguments and evidentiary questions as to what property the parties meant to cover by the description.

In addition, the applicable state entity statutes and organizational documents may use terms to describe an equity interest that should be considered in drafting a collateral description for a security agreement.

In the case of state entity statutes, for example, the Delaware LLC Act does not use the term “membership interest” and instead refers to a member’s (i) economic rights, (ii) control rights, and (iii) member status. In addition, the Delaware LLC Act limits its definition of “limited liability company interest” to economic rights (*i.e.* a member’s share of the profits and losses of the LLC and a member’s right to receive distributions of the LLC’s assets), see Delaware LLC Act Section 18-101(8), and therefore the term limited liability company interest as defined in the Delaware LLC Act does not include (i) the right to manage or control, (ii) the right to information and review of books and records, or (iii) the right to compel dissolution. Compare the New York LLC Act, which defines a “membership interest” more broadly (*i.e.* as a member’s aggregate rights in a limited liability company including, without limitation, (i) the member’s right to a share of the profits and losses of the LLC, (ii) the right to receive

Attachment of the security interest is a necessary pre-condition to the perfection of a security interest,<sup>34</sup> which in turn is critical protection of the security interest in an insolvency of the debtor, priority and the availability of protected purchaser, free of claims and similar protections for the secured party.

## **B. Delivery or Control as Substitute for Authenticated Record**

Section 9-203 provides for a limited number of “substitutes” for an authenticated record that evidences a security agreement:

- a. In the case of certificated securities in registered form, delivery of the security certificate to the secured party under Section 8-301 pursuant to the debtor’s security agreement.
- b. In the case of investment property (including certificated and uncertificated securities and security entitlements), control by the secured party under Section 9-106 pursuant to the debtor’s security agreement.<sup>35</sup>

For transaction planning purposes, given the evidentiary issues in proving that the debtor granted a security interest to the secured party and the obligations secured by the collateral in the absence of an authenticated record (as well as related opinion issues),<sup>36</sup> these provisions are generally not relied upon in commercial finance transactions.

## **V. PERFECTION OF SECURITY INTEREST**

**Exhibit E** provides an analysis of perfection methods available for general intangibles and for certificated and uncertificated securities and securities accounts, **Exhibit F** provides an analysis of the choice of law provisions applicable to the perfection of a security interest in certificated and uncertificated securities and securities accounts (which is based on the perfection method) and **Exhibit G** provides an analysis of the choice of law provisions applicable to the effect of perfection or nonperfection and the priority of a security interest in

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distributions from the LLC, and (iii) the member’s right to vote and participate in the management of the LLC). See NY LLC Act Section 102(r).

This issue is discussed in detail in N. Powell and J. Prendergast, *Mezzanine Loans – The Vagaries of Membership Interests as Collateral* (2010), available at the American College of Commercial Finance Lawyers Inc. ([www.accfl.com](http://www.accfl.com)) website: [http://accfl.com/system/datas/25/original/LLC\\_Mezz\\_Foreclosure\\_Article\\_Master\\_with\\_footnotes\\_2010\\_.pdf](http://accfl.com/system/datas/25/original/LLC_Mezz_Foreclosure_Article_Master_with_footnotes_2010_.pdf) or at <http://www.youngconaway.com/imezzanine-loans---the-vagaries-of-membership-interest-collaterali-the-practical-real-estate-lawyer-september-2010-09-01-2010/>

<sup>34</sup> Section 9-308(a).

<sup>35</sup> Section 9-206 provides for automatic attachment of a security interest in a security entitlement in limited circumstances although these provisions are not likely to apply to transactions involving LLC or partnership interests.

<sup>36</sup> See Part X.B below.

certificated and uncertificated securities and securities accounts (which is based on the category of investment property).

### **A. General Intangibles**

Filing of a financing statement is the only means of perfecting a collateral security interest in a general intangible.<sup>37</sup>

### **B. Certificated Security**

In addition to perfection by filing, perfection by possession (delivery or control) is applicable to a certificated security.<sup>38</sup>

Obtaining control of a certificated security requires delivery<sup>39</sup> of the certificate to the secured party together with either (i) an effective indorsement<sup>40</sup> of the security (either on the certificate or a separate stock power or similar form of assignment separate from certificate) to the secured party or in blank, or (ii) registration of the security in the name of the secured party.<sup>41</sup>

While delivery of a certificated security to the secured party is sufficient to perfect a security interest in that security, it is not control and therefore will not qualify the secured party for protected purchaser status, as discussed in Part VI.A below.<sup>42</sup>

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<sup>37</sup> Section 9-310. If the collateral can be categorized as a payment intangible, then a sale of the collateral would be a security interest subject to Article 9 and would be automatically perfected. *See* Section 9-309(3).

<sup>38</sup> Sections 9-310, 9-312, 9-313, 9-314. Temporary perfection is also available with respect to certificated securities. *See* Section 9-312(e), (g) and (h). Automatic perfection is available for certain security interests in securities, *see* Sections 9-309(9) and (10), although these provisions are not likely to apply to transactions involving LLC or partnership interests.

<sup>39</sup> The requirements for “delivery” are discussed in Section 8-301. Possession by the secured party is sufficient for delivery, as are specified situations in which a third party holds for the secured party.

<sup>40</sup> A forged or other unauthorized indorsement is not “effective.” *See* Section 8-107 and Official Comments to Section 8-107. However, a secured party that obtains a certificated security with an ineffective indorsement and has the security registered in its name will have control of the security (perfecting its security interest) and can qualify as a protected purchaser. *See* Section 8-106(b), Section 8-303 and Official Comment 3 to Section 8-303; *see also* James Steven Rogers, *Policy Perspectives on Revised U.C.C. Article 8*, 43 UCLA L. REV. 1431, 1464 (1996). The issuer may be liable under Section 8-404 for a transfer pursuant to an ineffective indorsement.

Registration of an LLC or partnership interest in the name of the secured party is not likely to occur, in which case protection from a forged indorsement will not be available to a secured party with a certificated interest as collateral.

<sup>41</sup> Sections 8-106(b), 9-106(a).

<sup>42</sup> In addition, without control of the collateral the secured party may have difficulty effecting a transfer of its collateral or exercising other remedies following default. Section 9-607 determines the rights between the secured party and the debtor in the exercise of secured party remedies, but not the duties of

### C. Uncertificated Security

In addition to perfection by filing, perfection by control is applicable to an uncertificated security.<sup>43</sup>

Obtaining control of an uncertificated security requires either (i) re-registration of the interest in the name of the secured party, which is not likely to be an available means of holding an LLC or partnership interest, or (ii) the issuer has agreed that it will comply with instructions<sup>44</sup> originated by the secured party without further consent by the registered owner.<sup>45</sup>

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an account debtor, bank or other person obligated on the collateral. In the case of an account debtor, bank or other obligor, other provisions of Article 9, other law or an agreement will determine the rights of the secured party against such person. *See* Section 9-607(e) and Official Comments 6 and 7 to Section 9-607. *See also Braunstein v. Pickens*, 593 F.Supp.2d 834 (D. S.C. 2009) (pledged certificates were not endorsed and therefore could not be transferred by secured party). A secured party that has perfected by control of collateral will have the rights provided by taking control and (if applicable) the terms of the related control agreement.

With respect to payment obligations, Section 9-406(a) provides the secured party with direct collection rights with respect to certain types of collateral (subject to the limitations specified in Section 9-406) and that the account debtor on an account, chattel paper or payment intangible is not discharged if it continues to make payment to the assignor after the account debtor receives an appropriate notice of the assignment of the payment obligation and direction to make payment to the assignee. Note that Section 9-406(a) does not apply to an obligor with respect to other property, including investment property, and that for payment obligations that are not subject to Section 9-406(a) as well as other obligations the secured party's rights against account debtors or other obligors may be limited or may require a judicial proceeding to enforce. *See Contractual Restrictions and Payment Obligation*, note 81 *infra*.

<sup>43</sup> Sections 9-310, 9-312, 9-314. Automatic perfection is available for certain security interests in securities, *see* Sections 9-309(9) and (10), although these provisions are not likely to apply to transactions involving LLC or partnership interests.

<sup>44</sup> Section 8-102(a)(12) defines instructions as “a notification communicated to the issuer of an uncertificated security which directs that the transfer of the security be registered or that the security be redeemed.”

<sup>45</sup> Section 8-106(c), 9-106(a). *See also* Section 8-106(f) (a purchaser (including a secured party) that has satisfied the requirements of Section 8-106(c) or (d) has control, even if the registered owner in the case of subsection (c) or the entitlement holder in the case of subsection (d) retains the right to make substitutions, to originate instructions or entitlement orders, as applicable, or otherwise to deal with the uncertificated security or security entitlement).

Delaware has added a non-uniform provision that provides a third method for obtaining control of an uncertificated security. Section 8-106(c)(3) of the Delaware UCC provides that a secured party has control of an uncertificated security if “the issuer, the registered owner and the purchaser [*i.e.* the secured party] have authenticated a record that (i) is conspicuously denominated a control agreement, (ii) identifies the uncertificated security in which the purchaser claims an interest, and (iii) contains one or more provisions addressing instructions relating to the uncertificated security or the right to originate instructions relating to the uncertificated security.” This form of control may not provide sufficient rights for the secured party to require the issuer effect transfers in light of the limitations in Section 9-607. *See* note 42 *supra*.



Control is required for the secured party to obtain the benefits of protected purchaser status as discussed in Part VI.A below.<sup>46</sup>

#### D. Security Entitlements/Securities Account

In addition to perfection by filing, perfection by control is applicable to a security entitlement or securities account.<sup>47</sup>

Obtaining control of a security entitlement (or a securities account, which is made up of security entitlements)<sup>48</sup> requires that (i) the secured party becomes the entitlement holder,<sup>49</sup> (ii) the securities intermediary<sup>50</sup> has agreed that it will comply with entitlement orders<sup>51</sup> originated by the secured party without further consent of the entitlement holder, or (iii) another person has control of the security entitlement on behalf of the secured party or, having previously acquired control of the security entitlement, acknowledges that it has control on behalf of the secured party.<sup>52</sup> If an interest in a security entitlement is granted to the entitlement holder's own securities intermediary, the securities intermediary has control.<sup>53</sup>

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<sup>46</sup> See note 42 *supra* for additional discussion of the benefits of obtaining control of collateral.

<sup>47</sup> Sections 9-310, 9-312, 9-314. Automatic perfection is available for certain security interests in securities, *see* Section 9-309(9) and (10), although these provisions are not likely to apply to transactions involving LLC or partnership interests.

<sup>48</sup> See note 13 *supra*.

<sup>49</sup> Section 8-102(a)(7) defines an “**entitlement holder**” as a person identified in the records of a securities intermediary as the person having a security entitlement against the securities intermediary. In essence, the entitlement holder is the customer of the securities intermediary where the relevant securities account is maintained.

<sup>50</sup> Section 8-102(a)(14) defines a “**securities intermediary**” as (i) a clearing corporation (defined in Section 8-102(a)(5) and including intermediaries such as DTC) or (ii) a person, including a bank or broker, that in the ordinary course of its business maintains securities accounts for others and is acting in that capacity.

Generally a secured party will have a representation from the intermediary that it is acting as a securities intermediary in a particular transaction, that the relevant account is a securities account and that the assets held in the securities account are securities entitlements.

<sup>51</sup> Section 8-102(a)(8) defines an “**entitlement order**” as a notification to a securities intermediary directing transfer or redemption of a security entitlement or other financial asset to which the entitlement holder has a security entitlement.

<sup>52</sup> Sections 8-106(d), 9-106(a). *See also* Section 8-106(f) (a purchaser (including a secured party) that has satisfied the requirements of Section 8-106(c) or (d) has control, even if the registered owner in the case of subsection (c) or the entitlement holder in the case of subsection (d) retains the right to make substitutions, to originate instructions or entitlement orders, as applicable, or otherwise to deal with the uncertificated security or security entitlement).

Delaware has added a non-uniform provision that provides a fourth method for obtaining control of a security entitlement. Section 8-106(d)(4) of the Delaware UCC provides that a secured party has control of a security entitlement if “the securities intermediary, the entitlement holder, and the purchaser [*i.e.* the secured party] have authenticated a record that (i) is conspicuously denominated a control agreement, (ii) identifies the security entitlement in which the purchaser claims an interest, and

Control (by the method of the secured party being an entitlement holder) is required for the secured party to obtain the benefits of the free of claims and similar provisions (analogous to protected purchaser status with respect to certificated and uncertificated securities) as discussed in Part VI.A below.<sup>54</sup>

## VI. BENEFITS OF AN OPT IN UNDER ARTICLE 8

### A. “Protected Purchaser” Status for Secured Party with Respect to Certificated and Uncertificated Securities

Section 8-303 provides that a purchaser (including a secured party) of a certificated or uncertificated security that meets the requirements to be a “protected purchaser” acquires its interest in the security free of any adverse claim.<sup>55</sup> This enables a secured party that meets the requirements of Section 8-303(a) to acquire better rights in the collateral than the debtor had – trumping the general rule of *nemo dat quod non habet* (“no one gives that which he does not have”).<sup>56</sup>

A “**protected purchaser**” is a purchaser of a certificated or uncertificated security, or of an interest therein, who:

- (1) gives value,
- (2) does not have notice of any adverse claim to the security, and
- (3) obtains control of the certificated or uncertificated security.<sup>57</sup>

“**Purchaser**” includes a secured party.<sup>58</sup> “**Value**” would include making a loan or a binding commitment to make a loan as well as past consideration.<sup>59</sup> Section 8-105 describes when a

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(iii) contains one or more provisions addressing entitlement orders relating to the security entitlement or the right to originate entitlement orders relating to the security entitlement.” This form of control may not provide sufficient rights for the secured party to require the securities intermediary effect transfers in light of the limitations in Section 9-607. *See* note 42 *supra*.

<sup>53</sup> *See* Section 8-106(e).

<sup>54</sup> *See* note 42 *supra* for additional discussion of the benefits of obtaining control of collateral.

<sup>55</sup> “**Adverse claim**” is defined in Section 8-102(a)(1) and discussed in Official Comment 1 to Section 8-102. *See Meadow Homes Development Corp. v. Bowens*, 211 P.3d 743 (Colo. App. 2009) (discussion of whether claimant had a property interest that constituted an adverse claim to a security).

<sup>56</sup> *See TriBar Revised Article 9 Report*, note 27 *supra*, at 1468 (a security interest in collateral in some circumstances is not limited to the debtor’s rights in the collateral to the extent described in Section 8-303).

<sup>57</sup> Section 8-303(a). Delivery is not sufficient to confer protected purchaser status, nor is perfection by filing.

<sup>58</sup> Section 1-201(b)(29) and (30) (Former Section 1-201(32) and (33)). The protection provided by Section 8-303 is recognized in Article 9. *See* Section 9-331(a) and Official Comment 2 to Section 9-331.

person has “**notice of an adverse claim.**”<sup>60</sup> The means of obtaining “**control**” of a security are described in Part V.B above (with respect to certificated securities) and V.C above (with respect to uncertificated securities).

Where the protected purchaser is a secured lender, a previously perfected security interest in a security will be subordinated (by operation of Section 9-328) rather than extinguished by the “takes free” language in Section 8-303.<sup>61</sup>

There is no comparable protection available to a secured party whose collateral is a general intangible.<sup>62</sup>

## **B. Priority if Perfect by Control or Delivery**

A security interest in a general intangible can only be perfected by the filing of a financing statement,<sup>63</sup> and the priority of competing security interests in a general intangible is determined by the “first to file” rules.<sup>64</sup>

In contrast, a security interest in a security can be perfected either by filing or by control (or, in the case of a certificated security, by delivery (*i.e.* possession of the certificate by the secured party or certain third parties)).<sup>65</sup> Only perfection by control will qualify the secured party for protected purchaser status with respect to a security, as described in Part VI.A above.

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<sup>59</sup> Section 1-204 (Former Section 1-201(44)). *See also* Section 8-116 (securities intermediary as a purchaser for value).

<sup>60</sup> The “good faith” requirement found in the definition of “bona fide purchaser” in Former Article 8 is not part of the definition of “protected purchaser.” *See* Official Comment 4 to Section 8-303.

<sup>61</sup> *See* Official Comment 2 to Section 9-331, which states that “whether a holder or purchaser referred to in Section 9-331 [including a protected purchaser] takes free or is senior to a security interest depends on whether the purchaser is a buyer of the collateral or takes a security interest in it.”

<sup>62</sup> Sections 8-502 and 8-510 provide a person that acquires a security entitlement protections analogous to the protected purchaser status provided in Section 8-303. *See* Sections 8-502, 8-503, 8-510 and 8-511. Where the person that takes free of claims or has similar protections under Sections 8-502 and 8-510 is a secured lender, a previously perfected security interest in a security will likely be subordinated (by operation of Section 9-328) rather than extinguished by Section 8-502 or 8-510. Section 8-510 expressly qualifies its effect to cases not covered by the priority rules in Article 9, but Section 8-502 does not contain such a qualification. Official Comment 2 to Section 9-331, which states that “whether a holder or purchaser referred to in Section 9-331 [including a protected purchaser] takes free or is senior to a security interest depends on whether the purchaser is a buyer of the collateral or takes a security interest in it.” While this language does not refer expressly to persons protected from claims under Sections 8-502, a different result from that with respect to Sections 8-303 and 8-510 may not be intended.

<sup>63</sup> Section 9-310.

<sup>64</sup> Section 9-322.

<sup>65</sup> Sections 9-310, 9-312, 9-313 and 9-314; Sections 8-106 (means of obtaining control) and 9-106(a); Section 8-301 (delivery). *See* Part V above.

The priority of competing security interests in a security perfected by filing would be determined by the “first to file” rules.<sup>66</sup> A security interest in a security perfected by control (or by delivery of a certificated security) would have the benefit of different priority rules, and in most cases would take priority over a competing security interest that had previously been perfected by filing (even if the subsequent secured party had knowledge of the competing security interest).<sup>67</sup>

Similarly, a security interest in a security entitlement (or securities account) can be perfected either by filing or by control.<sup>68</sup>

The priority of competing security interests in a security entitlement perfected by filing would be determined by the “first to file” rules.<sup>69</sup> A security interest in a security entitlement perfected by control would have the benefit of different priority rules, and in most cases would take priority over a competing security interest that had previously been perfected by filing (even if the subsequent secured party had knowledge of the competing security interest).<sup>70</sup>

There is no comparable non-filing priority available to the holder of a security interest in a general intangible.

### **C. Flexibility in Method of Perfection**

There may be circumstances where filing is a burdensome means of perfecting a security interest and control or delivery is more efficient. For example, consider a transaction in which every partner in a partnership has an obligation to contribute capital, and if a partner does not contribute, the other partners can make the contribution as a deemed loan to the noncontributing partner and be granted a security interest in the noncontributor's partnership interest to secure those loans. If there are 10 partners (so that each is potentially a secured party with respect to 9 other partners), then a single control agreement with the partnership (rather than multiple financing statement filings or the cost of a third-party collateral agent arrangement) may be the most efficient way to handle perfection. In states that impose significant recordation or stamp taxes on UCC filings, the ability to perfect by control could also be used to reduce transaction costs.<sup>71</sup>

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<sup>66</sup> Section 9-322.

<sup>67</sup> Section 9-328; Official Comments to Section 9-328. “Superpriority” status is available for certain security interests in securities, *see* Section 9-328, although these are not likely to apply to transactions involving LLC or partnership interests.

<sup>68</sup> Sections 9-310, 9-312 and 9-314; Sections 8-106 (means of obtaining control) and 9-106(a). *See* Part V above.

<sup>69</sup> Section 9-322.

<sup>70</sup> Section 9-328; Official Comments to Section 9-328. “Superpriority” status is available for certain security interests in security entitlements, *see* Section 9-328, although these are not likely to apply to transactions involving LLC or partnership interests.

<sup>71</sup> In each case, the cost savings and other benefits would need to be weighed against any risks posed by not filing a financing statement as a supplemental means of perfecting the security interest.

There are no provisions for non-filing perfection of a collateral security interest in a general intangible.<sup>72</sup>

## **VII. BENEFITS OF CERTIFICATED SECURITIES UNDER ARTICLE 8**

### **A. Ability to Obtain Exclusive Control**

If the secured party has possession of a certificated security, no other party can obtain control; as a result there can be no protected purchaser that can take free of the security interest in the certificate and no competing secured party that can obtain priority by taking control or delivery of the certificate.

If a third party has possession of the certificate under Section 8-301(a)(2), however, then multiple secured parties could have control of the same certificated security. Article 9 provides a “first to obtain control has priority” rule,<sup>73</sup> but the secured party is relying on representations and warranties (of the debtor and of the third party) for assurances that it was the first to obtain control and therefore has priority under Article 9.

Generally obtaining control of a certificated security through re-registration in the name of the secured party is not available for LLC or partnership interests.

Control of an uncertificated security (unless re-registration in the name of the secured party is used, which is not likely to be an available means of holding LLC or partnership interests) depends on a control agreement with the issuer, and multiple parties can therefore acquire control. Again, Article 9 provides a “first to obtain control has priority” rule,<sup>74</sup> and again the secured party is relying on representations and warranties (of the debtor and of the issuer) for assurances that it was the first to obtain control and therefore has priority under Article 9.

Regardless of the category of the collateral (as a general intangible, security or security entitlement), the secured party will be depending on the accuracy of representations and warranties as to the interests in the issuer that are outstanding and the terms of those interests, and compliance with any agreements restricting the issuance of additional interests or modifications of the terms of the collateral.

### **B. Means of Obtaining Control May be Easier to Put Into Effect**

Article 8 provides means to obtain control of an uncertificated security (so that requiring an LLC or partnership interest to be certificated on top of opting in is not necessary for the secured party to be able to obtain control and the related benefits as to protected purchaser

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<sup>72</sup> Automatic perfection applies to a sale of a payment intangible (*see* Section 9-309(3)), which would not be applicable to a collateral security interest in an LLC or partnership interest.

<sup>73</sup> Section 9-328. The Article 9 priority rule is a change from Former Article 9, which provided that parties with control had equal priority in the certificated security. Former Section 9-115.

<sup>74</sup> Section 9-328.

status and control priority for its security interest). However, it may be easier to obtain control of a certificated security (by taking possession or other delivery of a certificate with an effective indorsement) than to obtain control of an uncertificated security (which would require either (i) re-registration of the interest in the name of the secured party, which is not likely to be an available means of holding an LLC or partnership interest, or (ii) a control agreement with the issuer).

While the issuer of the LLC or partnership interest may cooperate in an opt in to Article 8 and in providing for the interest to be certificated, it may be less willing to undertake the responsibilities (and potential liability) involved in its entering into a control agreement.

### **C. Protection Against Subsequent Purchasers and Other Persons**

Having information (such as the fact of the opt in, restrictions on modifying the opt in, other terms of the LLC agreement or partnership agreement and restrictions on assignment of the security (including restrictions on other security interests)) noted on a certificated security may provide the secured party with protections not available if the security is uncertificated.

By way of example, Section 8-105(a) specifies when a person has notice of an adverse claim for purposes of determining whether that person is a protected purchaser. Information that appears on a security certificate would generally provide sufficient notice; with respect to an uncertificated security it could be more difficult to prove notice.<sup>75</sup> Similarly, Section 8-202(a) provides that (i) even against a purchaser for value and without notice, the terms of a certificated security include terms stated on the certificate and terms made part of the security by reference on the certificate to another instrument, indenture or document and (ii) the terms of an uncertificated security include those stated in any instrument, indenture or document pursuant to which the security is issued.<sup>76</sup>

## **VIII. RESTRICTIONS ON ASSIGNMENT AND THE EFFECT OF OPTING IN**

### **A. Alienability of Debtor's Rights Generally**

Section 9-401(a) provides that except as otherwise provided in Sections 9-406, 9-407, 9-408 and 9-409, whether a debtor's rights in collateral may be voluntarily or involuntarily transferred is governed by law other than Article 9.<sup>77</sup> The UCC "type" of collateral applicable

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<sup>75</sup> Section 8-105 and Official Comments to Section 8-105.

<sup>76</sup> See Section 8-202(a), Official Comments 1-3 to Section 8-202.

<sup>77</sup> Official Comment 4 to Section 9-401 states that Section 9-401(a) addresses the question of whether property is necessarily transferable by virtue of its inclusion (*i.e.* its eligibility as collateral within the scope of Article 9) and gives a negative answer subject to the identified exceptions.

Sections 9-406 and 9-408 are addressed in detail in Part VIII.C below; Section 9-407 deals with leasehold interests and lessor's residual interests; Section 9-409 deals with letter-of-credit rights.

Section 9-401(b), which addresses the effect of negative pledge clauses, provides an additional exception to the general rule in Section 9-401(a). Section 9-401(b) provides that an agreement between the

to an equity interest (*i.e.* a general intangible or investment property) will have an effect on the non-Article 9 law that applies to this issue.

Opting in to Article 8, and having an LLC or partnership interest be a security covered by Article 8, means that consideration should be given to other provisions of Articles 8 and 9 that will be applicable (or no longer applicable) to the interest.

## **B. Restrictions on Transfer of a Security (Article 8)**

Section 8-204 provides that a restriction on transfer of a security imposed by the issuer, even if otherwise lawful, is ineffective against a person without knowledge of the restriction unless (1) the security is certificated and the restriction is noted conspicuously on the security certificate or (2) the security is uncertificated and the registered owner has been notified<sup>78</sup> of the restriction.

Section 8-209 provides that a lien in favor of the issuer upon a certificated security is valid against a purchaser only if the right of the issuer to the lien is noted conspicuously on the security certificate.

A person who transfers a certificated security or an uncertificated security, or takes other similar actions with respect to such securities, makes the warranties specified in Section 8-108 unless otherwise agreed.<sup>79</sup> Transfers of the security must comply with Sections 8-104 and 8-301.

Section 8-202 establishes responsibilities and defenses of the issuer of the security.

Section 8-207 establishes rights and duties of the issuer with respect to registered owners of the security.

Section 8-401 establishes the duty of the issuer to register transfers.<sup>80</sup> Section 8-402 permits the issuer to seek certain assurances in accordance with requests for transfer. Section 8-403 permits certain parties to demand that the issuer not register the transfer. Section 8-404 establishes the issuer's liability for wrongful transfer.

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debtor and secured party that prohibits a transfer of the debtor's rights in collateral or makes the transfer a default does not prevent the transfer from taking place. *See also* Official Comment 4 to Section 9-401.

<sup>78</sup> "Notice" is defined in Section 1-202 (Former Section 1-201(25)-(27)).

<sup>79</sup> As a practical matter these warranties are likely to be the same as those included in a contract for the sale of a security or in a security agreement.

<sup>80</sup> *See, e.g. Shearson Lehman Hutton Holdings Inc. v. Coated Sales, Inc.*, 697 F. Supp. 639 (SDNY 1988) (secured party sought injunction to compel issuer to register transfer of pledged corporate stock; court discusses limited grounds under Section 8-401 for issuer to refuse transfer and finds none applicable on facts presented).

Sections 8-405 and 8-406 establish procedures with respect to lost, destroyed or wrongfully taken securities certificates, including the effect of failure to notify the issuer if the certificate has been lost, apparently destroyed or wrongfully taken.

### C. Article 9 Negation of Anti-Assignment Provisions Not Applicable to Securities

When an issuer opts in to Article 8 with respect to an LLC or partnership interest, making the interest a security rather than a general intangible, the provisions in Part 4 of Article 9 that negate certain contractual and statutory limitations on the assignment of general intangibles as collateral will not be applicable to a security.<sup>81</sup>

Section 9-408 provides that some otherwise enforceable contractual restrictions and some statutory restrictions on the assignment<sup>82</sup> of certain types of collateral, including general intangibles,<sup>83</sup> are ineffective. As a result, for the types of property and types of restrictions to which it is applicable, Section 9-408 (i) enhances the ability of a secured party to create and perfect a security interest in personal property collateral and (ii) preserves the value of the collateral by preventing an assignment from causing a default, breach, right to terminate or similar adverse event.<sup>84</sup>

Section 9-408(a) only negates a contractual restriction on assignment in an agreement between the debtor and the account debtor (*i.e.* the issuer of the interest),<sup>85</sup> so state partnership and LLC law as well as the UCC will need to be reviewed to determine if the LLC or

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<sup>81</sup> For a discussion of the negation of anti-assignment provisions in Part 4 of Article 9, *see* L. Soukup and P. Russev, *Payment Obligations and Other Property as Collateral: Contractual Restrictions on Assignment Rendered Ineffective by Article 9*, 37 UCC LJ 5 (2005) (hereinafter *Contractual Restrictions*). For a discussion of the rights of a secured party to direct that it receive payments in respect of collateral, *see* L. Soukup and C. Lang, *Payment Obligations as Collateral: Obligation to Pay Secured Party and Effect on Defenses and Modification of Assigned Obligations under Article 9*, 37 UCC LJ 35 (2005) (hereinafter *Payment Obligations*).

<sup>82</sup> The term “**assignment**” may refer to a sale or to an assignment to secure the payment or performance of an obligation. *See* Official Comment 26 to Section 9-102 (stating that, depending on the context, the terms “transfer” and “assign” each may refer to the assignment or transfer of an outright ownership interest or to the assignment or transfer of a limited interest, such as a security interest).

<sup>83</sup> If the LLC or partnership interest can be categorized as a payment intangible (a type of general intangible) then the broader negation provisions of Section 9-406 may apply. *See Contractual Restrictions*, note 81 *supra*.

<sup>84</sup> Section 9-408(c) and (e) negate certain statutory restrictions on assignment, subject to limitations on the categories of collateral and types of security interests covered and on the types of restrictions negated that are similar to the limitations applicable to the negation of contractual restrictions on assignment under Section 9-408(a). Article 9 (as a state law) will not negate U.S. federal laws restricting assignments and generally will not negate anti-assignment laws of other countries. *See Contractual Restrictions*, note 81 *supra*.

<sup>85</sup> With respect to some obligations the other members of the LLC or other partners may be the “account debtor,” which will alter the analysis.



partnership agreement qualifies as such an agreement (and the benefits of Section 9-408(a) that would have been available if the interest were a general intangible would be lost if an opt in were effected). In addition variations in state adoptions of the UCC and the provisions of state entity statutes in the relevant states<sup>86</sup> need to be reviewed, since some states have added provisions specifically to give effect to transfer restrictions applicable to LLC and partnership interests notwithstanding the provisions of Part 4 of Article 9.<sup>87</sup>

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<sup>86</sup> Sections 9-301 through 9-307 (the mandatory choice of law provisions applicable to the issues of perfection, the effect of perfection and nonperfection, and priority of security interests) will not apply to the determination of which state(s)' version of Section 9-406 or 9-408 will determine the effectiveness of contractual restrictions on assignment. *See* Official Comment 3 to Section 9-401. The law that the debtor and secured party have chosen to govern their agreement also is not likely to be the relevant law to apply in determining whether anti-assignment provisions are ineffective under Sections 9-406(d) and 9-408(a), and non-UCC choice of law principles will generally apply to determine which state(s)' version of Section 9-406 or 9-408 will control. *See* Official Comment 3 to Section 9-401; *see also* Section 1-302(a), (b) (Former Section 1-102(3)), Official Comments 1-3 to Section 1-302, Official Comment 2 to Former Section 1-102. For example, the law chosen by the parties to govern an agreement containing the anti-assignment provision is likely to apply to the restrictions created by that agreement, while the law of the jurisdiction of formation of an entity is likely to apply to a restriction created by the organizational documents of that entity. *See* Official Comment 3 to Section 9-401; *see also* *Settlement Capital Corp. v. Pagan*, 649 F.Supp.2d 545, 555 n. 51 (N.D. Tex. 2009) (citing 6 AM.JUR. 2d *Assignments* § 10 (2009) which states that “[W]hile the validity of an assignment is determined by looking to the law of the forum with the most significant relationship to the assignment itself, the assignability of the right or obligation being assigned is determined by looking to the law that would govern the underlying contract”). While Section 8-110 provides choice of law rules applicable to issues relating to securities and other investment property, those choice of law rules will not be relevant to determining the state(s) whose law will govern the effectiveness of an anti-assignment provision because Sections 9-406 and 9-408 do not apply to investment property. However, a court might look by analogy to Section 8-110(a) (which specifies matters that are governed by the local law of the jurisdiction of organization of the issuer of a security) in addition to non-UCC choice of law principles to determine which state(s)' version of Section 9-406 or 9-408 would apply to a transaction. *See Contractual Restrictions*, note 81 *supra*.

<sup>87</sup> Delaware Revised Uniform Partnership Act Section 15-104(c), Delaware Revised Uniform Limited Partnership Act Section 17-1101(e) and Delaware Limited Liability Company Act Section 18-1101(e) provide that Sections 9-406 and 9-408 do not apply to any interest in a Delaware partnership (including all rights, powers and interests arising under a partnership agreement or the Delaware RUPA, a Delaware limited partnership (including all rights, powers and interests arising under a partnership agreement or the Delaware RULPA) or a Delaware limited liability company (including all rights, powers and interests arising under a limited liability company agreement or the Delaware Limited Liability Company Act), and that these provisions in the entity statutes prevail over Sections 9-406 and 9-408. An assignment of interests in such entities will be in part governed by Section 15-503 (with respect to a general partnership), Sections 17-702 and 17-704 (with respect to limited partnerships) and Sections 18-702 and 18-704 (with respect to a limited liability company), which recognize that an LLC or partnership agreement may restrict transfers of LLC or partnership interests. Delaware made conforming amendments to Sections 9-406 and 9-408, and also amended those provisions to exclude interests in specified types of trusts. Delaware's Section 9-406(i)(4) provides that Section 9-406 does not apply to “an interest in a trust, including any right or power of a beneficiary (including a settlor) or owner of a trust, arising under a governing instrument (as defined in Section 3301(d) of Title 12), Title

To provide certainty that a security interest can be created, perfected and enforced, the secured party should obtain consent of the appropriate parties; even if Section 9-408 is applicable to negate a transfer restriction, Section 9-408(a) would only permit the creation, attachment and perfection of a security interest, and would not negate a restriction on enforcement of the security interest and related disposition of the collateral and would not require the issuer of the interest to recognize the rights of or deal with the secured party.<sup>88</sup>

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12, or other applicable law, to the extent that Delaware law governs such interest” and Delaware’s Section 9-406(i)(5) provides that Section 9-406 does not apply to “an interest in a partnership or limited liability company.” Similarly, Delaware’s Section 9-408(e)(3) and (4) excludes these types of interests in trusts, partnerships and LLCs from Section 9-408. The language in the Delaware statutes is broad enough to cover a distribution in respect of an interest (since the right to that distribution would arise under the LLC or partnership agreement).

Virginia Sections 9-406 and 9-408 provide that interests in partnerships and limited liability companies are excluded from Sections 9-406 and 9-408. *See* Virginia Section 9A-406(k) and 9A-408(g). Virginia Limited Liability Company Act Section 13.1-1001.1(B) provides that Sections 9-406 and 9-408 of the Uniform Commercial Code (including Sections 9A-406 and 9A-408 as enacted in Virginia) do not apply to any interest in a limited liability company, including all rights, powers and interests arising under the articles of organization or operating agreement of a limited liability company or the Virginia LLC Act and Section 50-73.84 of the Virginia Uniform Partnership Act contains similar language relating to partnerships. The language in Virginia statutes is broad enough to cover a distribution in respect of an interest (since the right to that distribution would arise under the LLC or partnership agreement).

Kentucky has similar provisions in its LLC and partnership statutes. *See* KRS Section 275.255(4) (“limitations upon the assignment or pledge of a membership interest set forth or adopted in accordance with this section shall be enforced notwithstanding KRS 355.9-406 and 355.9-408” in Kentucky LLC Act); KRS Section 662.1-503(7) (similar in Kentucky RUPA); KRS Section 362.2-702(8) (similar in Kentucky RULPA).

Texas has similar provisions in its LLC and partnership statutes as well as nonuniform versions of Section 9-406 and 9-408. *See* Section 101.106(c) of the Texas Business Organizations Code (providing that (i) Sections 9-406 and 9-408 of the Texas UCC do not apply to a membership interest in an LLC, including the rights, powers and interests arising under the LLC’s certificate of formation or LLC agreement or under the Texas LLC statute, (ii) to the extent of any conflict between this provision and Section 9-406 or 9-408 of the Texas UCC, this provision controls and (iii) it is the express intent of the provision to permit the enforcement, as a contract among the members of the LLC, of any provision of the LLC agreement that would otherwise be ineffective under Section 9-406 or 9-408 of the Texas UCC) and Section 154.001(d) of the Texas Business Organizations Code (similar language with respect to partnerships). Conforming amendments (stating that the sections were not applicable to an interest in an LLC or a partnership) were made to the Texas versions of Sections 9-406 and 9-408.

In addition a number of states did not enact Sections 9-406(j) and/or 9-408(e) (negating statutory restrictions on assignment) and in those states the applicable entity statute and other statutes that restriction transfers should be reviewed. *See, e.g.*, New York Uniform Commercial Code Sections 9-406, 9-408.

<sup>88</sup> *See* 9-408(d); *see also Contractual Restrictions and Payment Obligations*, note 81 *supra*, which analyze whether payment rights related to an LLC or partnership interest may be assigned separately from the underlying interest and related issues. *See also Johnson v. Cottonport Bank*, 259 B.R. 125 (Bankr. W.D. La. 2000) (where debtor grants security interest in the right to receive a stream of future

**Exhibit H** summarizes the analysis of the applicability of the negation of anti-assignment provisions in Part 4 of Article 9 to LLC and partnership interest.

If Part 4 of Article 9 does not negate a restriction on assignment, then other state law determines the effect of the restriction.<sup>89</sup>

## **IX. RISKS TO THE SECURED PARTY OF REQUIRING A CERTIFICATED INTEREST**

### **A. Dilution Upon Issuance of Replacement Certificate**

In the case of a certificated security, the secured party can be adversely affected if the debtor falsely claims that its certificate (in fact in the possession of the secured party or a third party) was lost, destroyed or stolen and obtains a replacement (which could result in dilution of the value of the secured party's collateral if a protected purchaser acquires rights in the new certificate).<sup>90</sup> This risk can be mitigated by notifying the issuer that the certificate has been pledged and is in the possession of the secured party or third party, and by having the issuer agree that it will not issue a replacement certificate without the secured party's consent.

### **B. Loss of Perfection**

If the secured party takes possession of a certificate and the certificate is then lost, destroyed or stolen, the secured party may lose perfection of its security interest if it did not also perfect by filing a financing statement.

It would also be possible for a protected purchaser to acquire the certificate and take free of (or have priority over) the secured party's security interest.

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payments, the security interest continues post-bankruptcy if the right to receive the payments existed prior to bankruptcy and the debtor need not do anything to make them continue; distinguishes cases in which debtor's post-bankruptcy assets or labor generate payments; citing additional cases); *In re Weiss*, 376 B.R. 867 (Bankr. N.D. Ill. 2007) (transfer restrictions applicable to LLC and limited partnership interests also applied to distributions). *cf. Goldberg & Connolly v. New York Community Bancorp, Inc.*, 565 F.3d 66 (2d Cir. 2009) (security agreement only applied to "all sums recovered" from a judgment, and not the judgment; since the "sums" arose later debtor did not have rights in the collateral until the sums arose and the security interest did not attach).

<sup>89</sup> See, e.g., *In re Weiss*, 376 B.R. 867 (Bankr. N.D. Ill. 2007) (debtor had no power to pledge interests in LLCs and partnerships because the prior approval of other owners or managers was not obtained as required in the applicable operating or partnership agreement, therefore lender had no security interest; Delaware and Illinois law applied as the governing law of the operating or partnership agreement; term "transfer" interpreted to mean granting of a security interest; court applied language prohibiting assignment of "any portion or part of the interest" to reject argument that proceeds of the interests could be assigned; 9-406 and 9-408 not addressed in the opinion).

<sup>90</sup> See Section 8-405(b).

### C. Secured Party Standard of Care in Custody of Certificate

The secured party has a duty to exercise reasonable care in the custody and preservation of collateral in the secured party's possession.<sup>91</sup> The debtor and secured party may by agreement set the applicable standard of care,<sup>92</sup> although the duty of care cannot be waived<sup>93</sup> and the agreed upon standard cannot be "manifestly unreasonable."<sup>94</sup> The secured party is liable for damages for breach of its duty of reasonable care.<sup>95</sup>

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<sup>91</sup> Section 9-207(a) provides that a secured party shall use reasonable care in the custody and preservation of collateral in the secured party's possession (subject to specified exceptions for buyers in transactions subject to Article 9, such as a buyer of promissory notes). In the case of chattel paper or an instrument, reasonable care includes taking necessary steps to preserve rights against prior parties unless otherwise agreed. *See* Section 9-207(a), Official Comment 2 to Section 9-207.

<sup>92</sup> Section 1-302(a), (b) (Former Section 1-102(3)), Official Comment 1-3 to Section 1-302, Official Comment 2 to Former Section 1-102, Official Comment 2 to Section 9-207, Official Comment 1 to Former Section 9-207 and Official Comment 2 to Section 9-602. Section 9-602, which lists rights and duties under Article 9 that cannot be varied by agreement, does not apply to Section 9-207(a). *See In re Krug*, 189 B.R. 948, 953, 960 (Bankr. D. Kan. 1995) (secured party had possession of collateral consisting of purebred cattle herd; the court found that the security agreement's language did not "specifically establish the standards of reasonable care to be applied in the transaction, and the standards by which the obligations are to be performed;" agreement stated that secured party's "duty of care with respect to collateral in its possession (as imposed by law) shall be deemed fulfilled if Secured Party exercises reasonable care in physically safekeeping such Collateral, or in the case of Collateral in the custody or possession of a bailee or other third party, exercised reasonable care in the selection of the bailee or other third person, and Secured Party need not otherwise preserve, protect, insure or care for any Collateral"); *Reed v. Central National Bank of Alva*, 421 F.2d 113, 117-18 (10<sup>th</sup> Cir. 1970) (secured party failed to exercise reasonable care when it failed to convert debentures prior to redemption date as requested by debtor and failed to tell debtor that it would not do so; exculpatory language in security agreement stating that secured party had no liability for failure to present for payment or collect the collateral did not constitute standard for reasonable care, which was the only thing that could modify secured party's duty of reasonable care; no conduct of the debtor relieved secured party of its duty); *Brodheim v. Chase Manhattan Bank, N.A.*, 347 N.Y.S.2d 394 (S. Ct. 1973) (under ordinary circumstances secured party's failure to give notice to pledgor of a conversion call would be a violation of secured party's duty to use reasonable care; pledgor had waived such notice in the security agreement and court upheld this as setting the applicable standard of care and not as an impermissible disclaimer or manifestly unreasonable even in the absence of sufficient evidence to show that such limiting agreements were standard practice in the banking industry; pledgor's own contributory negligence in failing to become aware of the conversion call would also defeat his claim); *Layne v. Bank One, Kentucky, N.A.*, 395 F.3d 271 (6<sup>th</sup> Cir. 2005) (discussion of 9-207 duties of secured party in possession of equity securities and analogous provisions of the Restatement of Security; cites additional cases).

<sup>93</sup> Section 1-302(b) (Former Section 1-102(3)), Official Comment 1 to Section 1-302, Official Comment 2 to Section 9-207, Official Comment 2 to Section 9-602. *See Brodheim* case discussed in note 92 *supra*.

<sup>94</sup> Section 1-302(b) (Former Section 1-102(3)).

The term "manifestly unreasonable" used in Section 1-302(b) (Former Section 1-103(3)), Section 9-603(a) (Former Section 9-501(3)) and Official Comment 2 to Section 9-603 is not defined in the UCC, nor do the comments to Sections 1-302 (Former Section 1-103) and 9-603 (Former Section 9-501)

In addition, while Article 9 does not create a duty of a secured party in possession of collateral to return the collateral to the debtor upon satisfaction of the secured obligations (or other conditions specified in their agreements), a secured party that fails to return collateral may be liable for damages.<sup>96</sup>

#### D. Controlling Distributions

Requiring an opt in and a certificated interest will not provide the secured party with the right to receive distributions in respect of the LLC or partnership interest. If receiving the distributions is important to the secured party, other actions (such as an agreement with the issuer of the interest) are needed.<sup>97</sup>

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provide direct guidance on the interpretation of this term. *See* Official Comment 1 to Section 1-302 (discussion of fixing a reasonable time refers to “by inadvertence or overreaching fixes a time so unreasonable . . . obviously unfair” and discussion of due diligence refers to Section 1-303 incorporating into the agreement prior course of dealing and usages of trade as being of particular importance); Official Comment 2 to Former Section 1-103 (similar language in discussion of due diligence). *See FDIC v. Webb*, 464 F. Supp. 520 (E.D. Tenn. 1978) (terms of note establishing secured party’s duty of care under 9-207 not manifestly unreasonable). *See generally* T. Zinnecker, THE DEFAULT PROVISIONS OF REVISED ARTICLE 9, 10-12 and notes 65-75 (1999). *See also* cases cite in note 92 *supra*.

<sup>95</sup> Section 9-625(b). Generally, a person is liable for damages in the amount of any loss caused by a failure to comply with Article 9; loss caused by a failure to comply may include loss resulting from the debtor’s inability to obtain or increased costs of alternative financing. Section 9-625(b), Official Comment 2 and 3 to Section 9-625.

The rights and duties in Section 9-625 cannot be waived or varied by agreement of the parties. Section 9-602(13) and Official Comment 3 to Section 9-602.

If not all of the parties that may assert a breach of the secured party’s duties are parties to the agreement that sets the standards for the secured party’s duty of reasonable care under Section 9-207(a) such parties may challenge as not satisfying this reasonable care standard the conduct that the secured party and the debtor have agreed meets that standard. *See* Official Comment 2 to Section 9-602 (“immediate parties, **as between themselves**, may vary [the UCC’s] provisions by agreement” [emphasis added]). The secured party will be liable for damages to a person that was, at the time of the secured party’s failure to comply with Article 9, a debtor or obligor or held a security interest or other lien on the collateral. Section 9-625(c)(1). The rights and duties in Section 9-625 cannot be waived or varied by agreement of the parties. Section 9-602(13) and Official Comment 3 to Section 9-602.

<sup>96</sup> While Article 9 does not provide a statutory obligation of the secured party to return collateral in its possession, it preserves common law duties to do so. *See* Official Comment 5 to 9-207, Official Comment 5 to 9-208. Under common law, absent agreement to the contrary the failure to relinquish possession of collateral upon satisfaction of the secured obligation would constitute a conversion. *See also Mountain Pure, LLC v. Bank of America*, 481 F.3d 573 (8<sup>th</sup> Cir. 2007) (attorney’s fees incurred as a result of bank’s delay in releasing stock were recoverable as special damages); *Segovia v. Equities First Holdings, Inc.*, 65 U.C.C. Rep. Serv.2d (Del. Super. 2008) (secured party that sold collateral prior to occurrence of default liable for conversion and breach of contract; conversion claim produced greater damages recovery).

<sup>97</sup> If distributions in respect of the interests are payment intangibles then under Section 9-406(a) the secured party may have the right to require that the issuer pay distributions to the secured party. *See*

While a purchaser of an LLC or partnership interest is not required to pay the purchase price to the secured party, it is likely to have conducted a UCC search and want a lien release that will permit the secured party to require payment be made to it.<sup>98</sup>

### **E. Reliance on Compliance by Debtor and Issuer**

The secured party is dependent on the accuracy of representations and warranties as to the interests in the issuer that are outstanding and on compliance with covenants restricting the issuance of additional interests or modifications of the terms of the interests.

## **X. LEGAL OPINIONS**

### **A. General**

The UCC collateral type applicable to an LLC or partnership interest raises a few additional considerations in the giving of attachment and perfection by filing opinions, and if the collateral is a security or security entitlement (including if there has been an opt in so that a pledged LLC or partnership interest is a security) there are additional opinions that may be appropriately requested.<sup>99</sup>

### **B. Creation**

The considerations in giving a creation opinion are the same for certificated and uncertificated securities, security entitlements and general intangibles – the opinion giver must evaluate the requirements in Section 9-203 for the attachment of a security interest:<sup>100</sup>

- Security agreement (evidenced by an authenticated record unless an exception to that requirement applies)<sup>101</sup>
- Value has been given satisfying the requirements of Section 1-204 (Former Section 1-201(44))

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*Payment Obligations* note 81 *supra* and discussion of non-uniform provisions in Delaware, Virginia, Kentucky and Texas in note 87 *supra*. See also *In re Weiss*, 376 B.R. 867 (Bankr. N.D. Ill. 2007) (transfer restrictions applicable to LLC and limited partnership interests also applied to distributions).

<sup>98</sup> See *Payment Obligations* note 81 *supra*.

<sup>99</sup> A complete analysis of security interest opinions is provided in the *TriBar Revised Article 9 Report*, note 27 *supra*.

<sup>100</sup> One of the Section 9-203 elements – that the debtor has rights in the collateral or the power to transfer rights in the collateral – is understood as not being covered by the opinion and is assumed. See *TriBar Revised Article 9 Report*, note 27 *supra*, at 1467-68.

<sup>101</sup> As discussed in Part IV.B in the case of investment property delivery or control may be a substitute for an authenticated record of the debtor's security agreement, but in an opinion context the absence of an authenticated record will present issues of how to determine that an agreement exists and what its terms are.

- Description of the collateral
  - If the description uses a UCC type (*e.g.* general intangible or security) rather than a functional description (*e.g.* “LLC interest”) an opt in can affect whether the description identifies the collateral<sup>102</sup>

### **C. Perfection**

#### ***Filing***

The considerations in giving a perfection by filing opinion are the same for certificated and uncertificated securities, security entitlements and general intangibles – the opinion giver must determine the correct jurisdiction for the filing based on the “location” of the debtor<sup>103</sup> and evaluate the requirements in Section 9-502 for the contents of the financing statement<sup>104</sup>

- Choice of law – perfection by filing is governed by the local law of the debtor’s location<sup>105</sup>
- The indication of collateral in the financing statement presents considerations similar to those for the collateral description in the financing statement, including regarding use of the correct collateral type<sup>106</sup>

#### ***Delivery (Possession)***

The considerations in an opinion covering perfection by possession (applicable to a certificated security) are:<sup>107</sup>

- Whether the secured party has obtained possession of the collateral, whether directly or through a qualifying third party<sup>108</sup>
- Choice of law – perfection by possession is governed by the local law of the jurisdiction where the collateral is located<sup>109</sup>

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<sup>102</sup> See also Part IV above, and in particular the discussion of state entity statute and entity governing documents in note 33 *supra*..

<sup>103</sup> Section 9-301 (local law of location of debtor the place of filing with respect to collateral other than certain real estate related collateral), 9-501(c)(1) (local law of location of debtor governs perfection of security interest in investment property by filing); 9-307 (determination of location of debtor).

<sup>104</sup> See generally *TriBar Revised Article 9 Report*, note 27 *supra*, at 1469-74.

<sup>105</sup> See note 103 *supra*.

<sup>106</sup> See also Part IV above, and in particular the discussion of state entity statute and entity governing documents in note 33 *supra*..

<sup>107</sup> See generally *TriBar Revised Article 9 Report*, note 27 *supra*, at 1469-76.

<sup>108</sup> See Part V.B above.

- Whether the statutory requirements have been met so that the interest is a certificated security<sup>110</sup>

### ***Control***

The considerations in an opinion covering perfection by control (applicable to a certificated or uncertificated security and to security entitlements) are:<sup>111</sup>

- Whether the applicable statutory requirements for control have been met<sup>112</sup>
- Choice of law – perfection by control is governed by the law of:
  - the jurisdiction where the collateral is located in the case of control of a certificated security<sup>113</sup>
  - the jurisdiction of organization of the issuer of an uncertificated security<sup>114</sup>
  - the securities intermediary’s jurisdiction with respect to a security entitlement<sup>115</sup>
- Whether the statutory requirements have been met so that the interest is a certificated security or uncertificated security, as applicable<sup>116</sup>

### **D. Priority and Protected Purchaser Status**

Because a certificated or uncertificated security has the additional benefit of control priority and the “takes free” rules applicable to a protected purchaser, additional opinions beyond creation and perfection may be requested:<sup>117</sup>

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<sup>109</sup> Sections 9-301(2), 9-305(a)(1).

<sup>110</sup> In the case of partnership and LLC interests, meeting the requirements in Section 8-103(c) for the interest to be a security will be required, as described in Part II.A above, in addition to meeting the requirements of applicable state laws and entity governing documents for the interest to be a certificated security.

<sup>111</sup> See generally *TriBar Revised Article 9 Report*, note 27 *supra*, at 1477.

<sup>112</sup> See Parts V.B and V.C above.

<sup>113</sup> Sections 9-301, 9-305(a)(1).

<sup>114</sup> Sections 9-301, 9-305(a)(2), 8-110(d).

<sup>115</sup> Sections 9-301, 9-305(a)(3), 8-110(e).

<sup>116</sup> See note 110 *supra*.

<sup>117</sup> See *TriBar Revised Article 9 Report*, note 27 *supra*, at 1493-1502.



- Priority – where control of a security is the means of perfection, control also provides priority over other secured parties and can be the basis for giving a limited priority opinion.<sup>118</sup>
- Protected purchaser status of the secured party – a protected purchaser “takes free” of adverse claims if the requirements of Section 8-303 are met (and can acquire better rights to the collateral than the debtor had).<sup>119</sup>

Similarly limited priority opinions and opinions as to free of claims and similar protections may be requested with respect to security entitlements.<sup>120</sup>

## **XI. UCC INSURANCE**

### **A. Lender Requirement**

A secured party with an LLC or partnership interest as collateral – for example in a real estate mezzanine loan – may require a UCC insurance policy covering the lender’s security interest in the equity collateral.

### **B. Insurer Requirements**

Qualifying for UCC insurance generally requires that the interest be subject to Article 8 (through an opt in of an LLC or partnership interest)<sup>121</sup> and that other actions be taken by the issuer of the interest and the debtor, such as an Article 8 matters proxy or rights of the secured party with respect to certain amendments of the partnership or LLC agreement (to prevent an “opt out”)<sup>122</sup> or certificating the interest.<sup>123</sup>

The insurer requirements are tied to having Article 8, and the related benefits of control priority and protected purchaser status discussed above, applicable to protect the secured party’s rights in the collateral. Without an opt in and additional protective steps, the policy may contain more exclusions and qualifications.

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<sup>118</sup> See *TriBar Revised Article 9 Report*, note 27 *supra*, at 1493, 1497-98, 1501-02.

<sup>119</sup> See *TriBar Revised Article 9 Report*, note 27 *supra*, at 1493-97.

<sup>120</sup> See *TriBar Revised Article 9 Report*, note 27 *supra*, at 1493, 1499-1502.

<sup>121</sup> See Part III.A above.

<sup>122</sup> See Part III.B above.

<sup>123</sup> In the case of newly formed special purpose entities, insurers may not impose some or all of these requirements.

## XII. FORECLOSURE

### A. Disposition of Collateral and Secured Party Purchase

Section 9-601(a) provides that after default, a secured party has the rights provided in Part 6 of Article 9 and, except as otherwise provided in Section 9-602, those provided by agreement of the parties.<sup>124</sup> Section 9-602 specifies those rights of a debtor or obligor (as applicable), and duties of the secured party, that are provided by Article 9 that may not be waived or varied by agreement.<sup>125</sup>

Section 9-610 permits a secured party to dispose of any or all of its collateral after default.<sup>126</sup> Every aspect of a disposition of collateral (including the method, manner, time, place and other terms) must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels and at any time or place and on any terms.<sup>127</sup>

Section 9-610(c) provides that a secured party may purchase collateral:

- (1) at a public disposition<sup>128</sup> or

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<sup>124</sup> The secured party's failure to comply with the requirements of Article 9 can lead to loss of a deficiency claim (Section 9-626), injunctive relief for the debtor (Section 9-625(a)), damages claims for any loss caused by failure to comply (including loss resulting from inability to obtain, or increased cost of, alternative financing) by the debtor, obligor, other secured parties or lienholders (Section 9-625(b)), loss of good faith transferee status (Section 9-617) and claims under other (non-UCC) law.

<sup>125</sup> A limited number of provisions may be waived following default. *See* Section 9-624.

In addition, Section 1-302 (Former Section 1-102(3)) addresses other UCC provisions that may not be varied by agreement. *See* Official Comment 2 to Section 9-602.

<sup>126</sup> Article 9 also provides the secured party with the remedies of collecting and enforcing its collateral and of strict foreclosure. *See* "UCC Article 9 and the Exercise of Secured Party Remedies," included in materials for the ABA 2008 Annual Meeting program *Getting Blood from a Stone: Commercially Reasonable Foreclosure on Collateral and the Availability of a Market* (August 9, 2008) and ABA Section of Business Law and Center for Continuing Legal Education Teleconference (June 2, 2009) (both available from [lynn.soukup@pillsburylaw.com](mailto:lynn.soukup@pillsburylaw.com)).

<sup>127</sup> Section 9-610(a) and (b). Former Section 9-504 contained comparable provisions.

In *Layne v. Bank One, Kentucky, N.A.*, 395 F.3d 271 (6<sup>th</sup> Cir. 2005), the court recognized that a delay in sale of collateral to permit resale of an affiliated person's restricted stock under Rule 144 requirements and that took into account market volume was not commercially unreasonable.

<sup>128</sup> The term "**public disposition**" is not defined in Article 9. Official Comment 7 to Section 9-610 states that for purposes of Article 9 a public disposition "is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. 'Meaningful opportunity' is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition)."

As discussed in Official Comment 7 to Section 9-610, Part 6 of Article 9 makes only two distinctions between "public" and other dispositions: (i) the secured party's ability to purchase at a non-public disposition is subject to limitations (as provided in Section 9-610(c)), and (ii) the debtor is entitled to

(2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.<sup>129</sup>

A “**recognized market**” is one in which the items sold are fungible and prices are not subject to individual negotiation (*e.g.* the New York Stock Exchange). A market in which prices are individually negotiated or the items are not fungible is not a recognized market, even if the items are the subject of widely disseminated price guides or are disposed of through dealer auctions.<sup>130</sup>

Section 9-610(c) is not one of the provisions of Article 9 that Section 9-602 expressly provides cannot be waived or varied by agreement of the parties. However, Official Comment 2 to Section 9-624 states “transactions [in which a secured party buys at its own private disposition] are equivalent to ‘strict foreclosures’ and are governed by Sections 9-620, 9-621, and 9-622,” and Sections 9-602(10) and 9-624 provide that (with a limited exception in consumer transactions) the provisions of Sections 9-620, 9-621 and 9-622 cannot be altered by agreement of the parties. As a result, Section 9-610(c) should be treated as a provision that the parties cannot waive or vary by agreement.

Section 9-603(a) provides that the parties may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party under a rule stated in Section 9-602 if the standards are not manifestly unreasonable.<sup>131</sup>

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notification of “the time and place of a public disposition” and notification of “the time after which” a private disposition or other intended disposition is to be made (as provided in Section 9-613(1)(E)). Article 9 does not retain the distinction made by Former Section 9-504(4), under which transferees in a noncomplying public disposition could lose protection more easily than transferees in other noncomplying dispositions; instead Section 9-617(b) adopts a unitary standard. *See also* Official Comment 3 to Section 9-617.

<sup>129</sup> Former Section 9-504 contained comparable provisions.

In addition (i) a secured party may purchase at an execution sale, *see* Section 9-601(f) and Official Comment 8 to Section 9-601, and (ii) if a security agreement covers both real and personal property a secured party may proceed as to both in accordance with the rights with respect to real property, *see* Section 9-604(a)(2) and Official Comment 2 to Section 9-604.

<sup>130</sup> *See* Official Comment 9 to Section 9-610; *see also* Official Comment 4 to Section 9-627. *See also* *Layne v. Bank One, Kentucky, N.A.*, 395 F.3d 271 (6<sup>th</sup> Cir. 2005) (discussion of protection afforded by sale on recognized market; identifies NASDAQ as a recognized market).

<sup>131</sup> *See also* Official Comment 2 to 9-603.

A secured party that includes such provisions in its loan documents runs the risk that its sale will not be found to be commercially reasonable where it fails to follow the specified procedures. *See Commercial Credit Group, Inc. v. Barber*, 682 S.E. 2d 760 (N.C. App. 2009) (security agreement specified that any foreclosure sale be for 25% cash down with the remainder due within 24 hours, sale as advertised stated secured party could require full immediate payment; court held that secured party could not rely on the terms of the security agreement). The *Commercial Credit Group* case is analyzed in Steven O. Weise, U.C.C. Survey – Personal Property Secured Transactions, 65 *The Business Lawyer* 1293, 1309 (2010).

Section 9-627(b) states that “[a] disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable practices among dealers in the type of property that was the subject of the disposition.” Section 9-627 can be altered by agreement of the parties.<sup>132</sup>

The *Burns* case discussed in Part XII.B below provides an example of the application of the concept of establishing foreclosure parameters by agreement.

## B. Cases

*Burns v. Anderson* (United States Court of Appeals for the Fourth Circuit, No. 03-2162, December 15, 2004, unpublished opinion) – available at <http://pacer.ca4.uscourts.gov/opinion.pdf/032162.U.pdf>

In *Burns*, the pledged stock was "thinly traded stock registered on the NASDAQ." The pledge agreement (i) provided that the collateral could be sold in a private sale (upon such terms and conditions as the secured party deemed advisable) and that the secured party could purchase the collateral at any sale, (ii) contained an acknowledgment by the pledgors that the pledged stock was “of a type customarily sold on a recognized market, in each case within the meaning of [Section 9-610]”, and (iii) included the following provision:

Pledgor[s] further recognize[] that the market for the Pledged Stock is illiquid and that a public sale of the Pledged Stock in a significant quantity could have an adverse effect on the market price for the Pledged Stock. Therefore, Pledgor[s] acknowledge[] and agree[] that . . . no private sale of the Pledged Stock (whether such sale is to the Pledgee [i.e. secured party] or to a third party) will be deemed to have been made in a commercially unreasonable manner for the reason that it was made at a price that reflects a discount from the then current market price of such Pledged Stock. Pledgor[s] further acknowledge[] and agree[] that, to the fullest extent permitted by applicable law, any such discount that is calculated in accordance with an appraisal of the Pledged Stock by an independent appraiser . . . shall be deemed to be commercially reasonable. [emphasis and deletions in original]

The appellate court found that the secured party had used the stock sale method provided for in the pledge agreement (*i.e.* appraised value) and that therefore the sale was commercially reasonable and that the requirements of Section 9-610 (permitting the secured party to buy at a private sale) were satisfied.<sup>133</sup>

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<sup>132</sup> See Sections 9-602, 9-624.

<sup>133</sup> **Exhibit C** provides a more detailed discussion of the *Burns* case and the issues raised by the recognized market exception permitting the secured party to purchase in a private sale.

***Vornado PS, L.L.C. v. Primestone Investment Partners, L.P., 821 A.2d 296, 49 UCC Rep.Serv.2d 1348 (Del. Ch. 2002)***

In *Vornado*, the court looked both at the process and the amount of the secured party's credit bid (which was at the market price of a NYSE publicly traded security (REIT stock) for which the collateral (partnership units) was exchangeable (subject to certain limitations)) to assess the commercial reasonableness of a public disposition of collateral at which the secured party was the sole bidder and the purchaser. The secured party had concluded that it could not purchase the collateral under Section 9-610(c) at a private sale because the pledged partnership units were not themselves publicly traded (although they were convertible, subject to limitations, into the publicly traded REIT stock).

The court noted that there had been a significant marketing process by the secured party's financial adviser. The secured party had retained Goldman Sachs to assist it in developing a marketing process and identifying potential purchasers of the collateral. The debtor was given 20 days prior notice of the public sale. A licensed auctioneer was retained. The sale was advertised in the New York Times twice (2 weeks and 1 week prior to the date of the auction) and in the Chicago Tribune once (about 2 weeks prior to the date of the auction). The secured party also contacted the debtor and the issuer of the REIT stock into which the pledged units were convertible seeking to have restrictions that made the collateral less marketable removed (the secured party's requests were rejected). Goldman Sachs assembled an information memorandum for potential bidders providing information about the collateral and the issuer of the units; the information memorandum only provided publicly available information and disclosed that the secured party might have other, non-public information, that might be material but was not being disclosed. (The court noted that the debtor could have chosen to provide such information to potential purchasers but refused to do so.) The secured party and Goldman Sachs compiled a list of and contacted 51 potential purchasers, including the issuer of the REIT securities. An additional 8 potential purchasers were contacted either through referrals or by unsolicited calls from those bidders. The borrower was also asked to provide a list of potential purchasers (but did not respond). Copies of the information memorandum were sent to 33 potential purchasers. When the sale was postponed several times, the marketing efforts continued. The court found that the efforts undertaken by Goldman Sachs were "consistent in all material respects with actions it has taken in the past in connection with other marketing processes relating to real-estate related companies and equity interests therein."

The final version of the information memorandum was provided to 42 potential purchasers, and three prospective purchasers in addition to the secured party attended the auction. The auction was held in New York, with one prospective purchaser participating by phone. The terms of the auction (including settlement and bidder qualification procedures) were specified in the final information memorandum. The borrower was not permitted to bid because it did not meet the bidding qualifications. The secured party's credit bid was equal to the closing share price of the related REIT shares on the day of the foreclosure sale, although because of the limited voting rights of the pledged partnership units and limitations on the conversion of the units into the publicly traded REIT shares with full voting rights, the units were likely worth less than the shares. The court referred to Section 9-627(b)(2) protection of a

disposition as commercially reasonable if the disposition is made “at the price current in any recognized market at the time of disposition.” The court rejected the debtor’s argument that the value of the units was the higher net asset value (and not market price) since the net asset value would only be realized on liquidation, the units did not have the right to cause liquidation, there was no indication of any plans to liquidate the partnership assets or that the partnership’s real estate assets would be easily liquidated.

The court rejected the debtor’s argument based on Official Comment 2 to Section 9-610 that that the collateral should have been sold in a private sale. While the comment states that the UCC encourages private dispositions, the court stated that such a “generalized policy” had to give way in this case to the fact that the secured party was one of the most interested and able potential purchasers and in a private sale (in which the secured party could not bid) the price for the collateral had the potential to be much lower.<sup>134</sup>

***Voutiritsas v. Intercounty Title Company, 664 N.E.2d 170 (Ill. App. 1996)***

In *Voutiritsas*, the court held that the secured party’s disposition of collateral was not commercially reasonable. The collateral being sold was a non-recourse promissory note secured by a second deed of trust on real estate located in Chicago. The published notice of the public sale of the collateral failed to identify or refer to either the real estate (located in Chicago) or to the deed of trust that secured the note. The published notice discouraged competitive bidding by only offering to sell a “claimed” 60% legal or equitable interest of the debtors in the note and by stating that the secured party claimed that it was the legal owner of the note. The secured party was the only bidding party that attended the auction; citing prior case law in Illinois, the court stated that improper notice could be inferred when no one but the secured party attends a public sale. The court also stated that the secured party’s credit bid – \$350,000 (which was about half of the secured obligation) for a \$3 million promissory note – was “without substance and lacking in foundation . . . was not based on any appraisal but rather was ‘pulled out of thin air’ based on a number [the secured party’s attorney] had in his mind.” The court noted that the trial record established that both parties considered the value of the collateral to be significantly greater than the secured party’s \$350,000 credit bid.

***Solfanelli v. Meridian Bank, 206 B.R. 699 (Bankr. M.D. Pa. 1996) aff’d in part and rev’d in part 230 B.R. 54 (M.D. Pa. 1999) aff’d 203 F.3d 197 (3d Cir. 2000)***

In *Solfanelli*, the Bankruptcy Court held that the secured party’s use of a “market maker” (described by the District Court as a registered broker with expertise in the relevant industry) to advise on the conduct of the sale of the collateral (stock traded on NASDAQ), sale at the NASDAQ bid price and the timing of and other aspects of the sale were commercially reasonable. The parties’ agreement provided that the sale of the pledged shares “either through a registered broker in the market or in a private sale at or higher than the NASDAQ ‘bid’ amount shall constitute a commercially reasonable sale.” However, failure of the secured party to disclose to the debtor settlement of claims against the market maker for self-

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<sup>134</sup> The *Vornado* case is analyzed in Steven O. Weise, U.C.C. Survey – Article 9 Developments, 59 *The Business Lawyer* 1649, 1660-61 and notes 125-130 (2004).

dealing that the secured party discovered after the sale closed did not meet the UCC's standards of good faith and commercially reasonable conduct and led to loss of a deficiency claim.

The District Court found that an eleven month delay in selling the collateral was inconsistent with industry standards and was not commercially reasonable (reversing that part of the Bankruptcy Court opinion). Prior to the event of default on the secured loan, the secured party had asked the debtor to sell the stock at \$16 per share (which would have produced proceeds greater than the amount of the debt), but then did not do so itself following the event of default even though the market was at \$16 per share or higher on a number of days. The court noted that there was no evidence that for the first 9 to 10 months after the event of default that the secured party took any action to effect a sale (noting that the secured party did not retain a broker, or set a plan for sale at a particular price, but "simply sat and waited"; expert witness testified he would have advised secured party to consider selling earlier; court did not accept justification of fear of suit by the debtor). During the delay the value of the stock eventually declined below an amount sufficient to pay the debt, and below the "floor" set as an event of default in the transaction documents. The District Court also noted that "the questionable conduct of the [secured party's] broker was sufficiently outside the ordinary course of anticipated events with respect to the sale that good faith and fair dealing demanded that the [debtor] be apprised of this development."

The Third Circuit affirmed, noting that (i) the secured party had not retained a broker or put in place a monitoring scheme or strategy for executing on the collateral, (ii) the secured party did not offer any credible explanation for retaining the collateral for 11 months after the event of default had occurred, and (iii) the fact that the debtor had not requested that the collateral be sold would be only one factor in determining the commercial reasonableness of the timing of the sale and would not preclude finding, based on the totality of the circumstances, that the sale was commercially unreasonable. The court also noted that the debtor had not asked the secured party to forebear from selling the pledged stock.

*Compare Beal Bank, SSB v. Sarich*, 67 U.C.C. Rep. Serv. 2d. 281 (Wash. Ct. App. 2008) (court rejects debtor's argument that three year delay in disposing of collateral was commercially unreasonable, stating Section 9-610 did not apply to decision to sell; this is inconsistent with the language of Official Comment 3 to Section 9-610, which states that "if a secured party . . . holds collateral for a long period of time without disposing of it, and if there is no good reason for not making a prompt disposition, the secured party may be determined not to have acted in a commercially reasonable manner).

### **C. Securities Law Considerations**

#### ***Equity Interests May be "Securities" under the Securities Laws***

If collateral is a security for purposes of the securities laws, then those laws may affect how the party can dispose of that collateral.

While the UCC definition of security is similar to the securities law definition, there are some differences. For example, under the securities laws whether an equity interest is a security is primarily determined by the degree of managerial control the holder exercises over the entity – in most cases a general partnership interest (or LLC interest involving a similar managerial role) is not a security, while a limited partnership interest (or LLC interest involving a similar managerial role) would be, although the label placed on an interest is not dispositive and in each case the functions that the holder of the interest performs must be evaluated.<sup>135</sup> The treatment of an equity interest as a security for purposes of the UCC does not depend on management control, but on the type of entity that issued the interest and other factors set out in Section 8-103(c).<sup>136</sup>

An opt in to Article 8 with respect to an LLC or partnership interest will not affect whether the interest is a “security” for purposes of federal or state securities laws or other non-UCC laws.<sup>137</sup> For purposes of assessing whether the securities laws apply to a disposition of collateral, the determination of whether the collateral is a security will be governed by the securities laws (and not by the UCC).

### ***UCC Public Sale Requirements May be Inconsistent with a Private Sale Under Securities Laws***

Section 9-610 permits a secured party to dispose of any or all of its collateral after default; the disposition of collateral may be through either public or private proceedings.<sup>138</sup> As described in Part XII.A and XII.B above, Section 9-610(c) provides that a secured party may purchase the collateral (i) at a public disposition or (ii) at a private disposition only if the collateral is of

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<sup>135</sup> See, e.g., *SEC v. Cont'l Wireless Cable Television, Inc.*, No. 95-56488, 1997 U.S. App. LEXIS 5899 (9th Cir. Mar. 26, 1997) (unpublished opinion) (general partnership interests were securities); *K.B.R., Inc. v. L.A. Smoothie Corp.*, No. 95-116, 1996 U.S. Dist. LEXIS 4552, at \*12-\*17 (E.D. La. Apr. 3, 1996) (general partnership or joint venture interest can be a security within the meaning of the 1933 Act if the investor can establish that an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership, which has long been held to be an investment contract; also if the partner or venturer lacks the business experience and expertise necessary to intelligently exercise partnership powers, or the partner or venturer is so dependant on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the promoter or manager or otherwise exercise meaningful partnership or venture power, the partnership interest may be an investment contract), *aff'd without opinion*, 136 F.3d 1328 (5th Cir. 1998); *Keith v. Black Diamond Advisors, Inc.*, 48 F. Supp. 2d 326 (S.D.N.Y. 1999) (LLC interest not a security, since LLC was a member managed LLC and purchaser intended to retain some control over and be involved in management of LLC; cites additional cases). In addition to whether an equity interest is a security for federal securities law purposes, consideration should be given to whether state securities laws might provide different standards and require compliance with state “blue sky” or other securities laws in connection with a disposition of the equity interests.

See generally L. Soukup, *Securities Law and the UCC: When Godzilla Meets Bambi*, 38 UCC LJ 3 (2005) (hereinafter *Securities Law and the UCC*).

<sup>136</sup> See discussion in Part II.A.

<sup>137</sup> See Section 8-102(d).

<sup>138</sup> Section 9-610(a) and (b). Former Section 9-504 contained comparable provisions.



a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.

As a result, a secured party that seeks to purchase the collateral at a foreclosure sale<sup>139</sup> may need to conduct a public disposition, and if it does not want to acquire the collateral for its own account may seek to conduct a public disposition as a means of obtaining the best price for the collateral.

Official Comment 7 to Section 9-610 states that for purposes of Article 9 a public disposition “is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. ‘Meaningful opportunity’ is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition).”<sup>140</sup> The need for advertising or public notice and public access raises concerns that the secured party’s public disposition may not qualify for an exemption from the registration requirements under the Securities Act of 1933 (the “**1933 Act**”).<sup>141</sup>

Official Comment 8 to Section 9-610 recognizes that

[d]ispositions of investment property [including securities] may be regulated by the federal securities laws. Although a “public” disposition of securities under this Article may implicate the registration requirements of the Securities Act of 1933, it need not do so. A disposition that qualifies for a “private placement” exemption under the Securities Act of 1933 nevertheless may constitute a “public” disposition within the meaning of this section. Moreover, the “commercially reasonable” requirements of subsection [9-610](b) need not prevent a secured party from conducting a foreclosure sale without the issuer’s compliance with federal registration requirements.<sup>142</sup>

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<sup>139</sup> Section 9-620 provides more flexibility than did Former Section 9-505(b) with respect to a strict foreclosure (*e.g.* expressly permitting a partial strict foreclosure and not limiting strict foreclosure to property in the possession of the secured party), and may permit the secured party to acquire the property without a public sale if the debtor and other specified parties in interest agree (or do not object) in accordance with the procedures set out in Section 9-620.

<sup>140</sup> See discussion in Part XII.A above,

<sup>141</sup> The requirement to register sales and other transfers of securities (unless an exemption is available) is discussed in I & II Louis Loss & Joel Seligman, *Securities Regulation* Chapter 2 (3d ed. 1999 and 2005 Supp.) and securities and transactions that are exempt from the registration requirement are discussed in III Louis Loss & Joel Seligman, *Securities Regulation* Chapter 3.B-C (3d ed. 1999 and 2005 Supp.).

<sup>142</sup> Section 9-610(b) provides that “Every aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and place and on any terms.” The requirements of Section 9-610(b) cannot be waived or varied by agreement, *see* Section 9-602(7), but the parties may determine by agreement the standards measuring the fulfillment of the duties of a secured party if the standards are not manifestly unreasonable, *see* Section 9-603(a).

### ***SEC No-Action Letters on UCC Public/Securities Law Private Sales***

The SEC has issued a number of no-action letters<sup>143</sup> that establish the steps to be taken so that a disposition of securities that qualifies as a public disposition of collateral for Article 9 purposes will not require registration under the 1933 Act.<sup>144</sup> The no-action letters generally impose the following requirements on the conduct of the sale:

- a) the pledged securities will be sold only as a block to a single purchaser, and will not be split up or broken down;
- b) the purchaser will represent that the securities will be taken with investment intent (*i.e.* that the securities are being acquired for the purchaser's own account and not with a view toward the sale or distribution thereof and will not be sold unless pursuant to an effective registration statement under the 1933 Act and applicable state securities laws or under a valid exemption from such registration);
- c) the securities will be subject to transfer restrictions (*e.g.* certificates for the pledged securities, when issued to the purchaser, will bear an appropriate legend to the effect that the securities represented thereby may not be sold or transferred

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See **Exhibit B** for sample language from a security agreement setting standards relating to the federal securities law aspects of a disposition of securities. For a specific transaction the language should be tailored to the specific interest. For example, the language might be modified to deal with (i) state securities laws, (ii) limitations on manner of sale or eligible purchasers relating to exemptions from the 1940 Act, the 1934 Act, ERISA or being a taxable entity, and (iii) limitations on who can own the pledged interests established by the entity governing documents, applicable regulatory regimes (*e.g.* U.S. federal statutes requiring that ownership or control of certain types of business be limited to U.S. citizens or other qualified owners) or the transaction document (*e.g.* the "qualified transferee" restrictions found in real estate mezzanine financing intercreditor agreements).

For additional discussion of foreclosure on collateral consisting of securities, *see Securities Law and the UCC*, note 135 *supra*.

<sup>143</sup> For a discussion of no-action letters as precedent, *see* Robert J. Haft & Arthur F. Haft, *Analysis of Key SEC No-Action Letters*, Preface, at vii-ix (2004-2005 ed.).

<sup>144</sup> *See Securities Law and the UCC*, note 135 *supra* for detailed analysis and a list of no-action letters addressing this issue; the list is not a complete list of all no-action letters on this issue. *See also A.D.M. Corp. v. Thomson*, 707 F.2d 25, 26-27 (1st Cir. 1983) (citing no-action letters stating that the pledgee's foreclosure sale of securities did not require registration under the 1933 Act as well as authorities critical of that view); Robert J. Haft & Arthur F. Haft, *Analysis of Key SEC No-Action Letters* § 7:34 (2004-2005 ed.) (discussing no-action letters relating to disposition of securities held as collateral through a sale that is a "public sale" for Article 9 purposes and concluding that, while not expressly stated in the staff responses, the likely basis for the position taken in the no-action letters is the so-called "4(1/2)" exemption, with an easing of its restrictions against general solicitation or advertising to accommodate Article 9 requirements for a "public disposition").

Other exemptions permitting a sale of collateral without registration under the 1933 Act, including Rule 144 under the 1933 Act, may be available to the secured party. *See, e.g. Shearson Lehman Hutton Holdings Inc. v. Coated Sales, Inc.*, 697 F. Supp. 639 (SDNY 1988) (discussion of applicability of Rule 144 to bona fide pledgee).

without registration under the 1933 Act and applicable state laws or the availability of a valid exemption from such registration),<sup>145</sup>

- d) the seller will provide on request to any prospective purchaser the information that the seller has concerning the issuer of the securities; and
- e) the public auction of the pledged securities will be conducted as prescribed under the UCC.<sup>146</sup>

The requesting letters commonly recite the following additional facts:

- a) the lender believed that the loan would be repaid in accordance with the loan documents and there would be no need to foreclose on the collateral for the loan (including the pledged securities);
- b) the lender is not an affiliate of the pledgor or the issuer of the pledged stock (*e.g.* the lender's only relationship with the pledgor was an arm's length lender - borrower/guarantor/pledgor relationship) and the transaction was entered into in the ordinary course of business of the lender;<sup>147</sup>
- c) notice of the sale will be given to every person required by applicable law and will be published in one or more newspapers and might also be published in trade or business journals or other periodicals or provided to selected prospective purchasers,<sup>148</sup>

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<sup>145</sup> See Russell Ranch, 1995 SEC No-Act. LEXIS 635 (Aug. 11, 1995) for an analogous procedure for securities not represented by a certificate.

<sup>146</sup> The no-action letters are described and analyzed in greater detail in *Securities Law and the UCC*, note 135 *supra*.

<sup>147</sup> See General Electric Capital Corporation, 1998 WL 727229 (SEC No-Action Letter Oct. 19, 1998) (noting that many of the no-action letters expressly state that the pledgee is not an affiliate of either the pledgor or the issuer; although there had been no express prohibition on the use of Section 4(1) exemption for a foreclosure sale by a pledgee that was also an affiliate of the issuer and in none of the SEC response letters was the grant of no-action relief specifically conditioned on the non-affiliate status of the pledgee; in the GECC letter pledgee became an affiliate of issuer due to right under pledge agreement if default had occurred to vote pledged shares (which pledgee exercised) and acquisition of 77% interest in issuer through exercise of pledgee remedies, pledgee planned to purchase the stock and not to resell it, and no-action relief was granted by the SEC).

<sup>148</sup> Official Comment 7 to Section 9-610 states that "a 'public disposition' is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. 'Meaningful opportunity' is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition)." This often leads to advertising the sale in a newspaper of general circulation (such as *The Wall Street Journal*) even if the collateral is not an asset that "the public" would (or is permitted) to buy (*e.g.* equity interests subject to transfer restrictions to maintain 1933 and 1940 Act exemptions). In *Ford & Vlahos v. ITT Commercial Finance Corp.*, 8 Cal. 4th 1220, 885 P.2d 877 (1994), the court discussed appropriate advertising and other efforts to publicize a public sale of collateral (aircraft) that would be of interest to

- d) the notice of sale will state that the secured party reserves the right to bid for and purchase the pledged securities and to credit the purchase price against the expenses of sale and the secured obligations;
- e) the lender is likely to be the purchaser of the pledged securities at the foreclosure sale; and
- f) no public market exists for the shares.<sup>149</sup>

The SEC has refused no-action relief under the following circumstances:

- a) the notes secured by the securities were received as part of the initial purchase price of the pledged securities and affiliated parties were involved in the transaction<sup>150</sup>
- b) litigation was currently pending involving the lender, the issuer of the pledged stock, the SEC and certain other persons.<sup>151</sup>

**Materials preparation date: January 1, 2011<sup>152</sup>**  
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a specific type of purchaser. In particular the court noted that “[n]otice of sale should be given to a ‘public’ reasonably expected to have an interest in the collateral“ and noted that placing a legal notice in a publication of general circulation might be insufficient to make the sale efforts commercially reasonable. *See also Commercial Credit Group, Inc. v. Barber*, 682 S.E.2d 760 (Ct. App. N.C. 2009) (insufficient efforts to reach buyers of specialized equipment; citing additional cases).

<sup>149</sup> The no-action letters are described and analyzed in greater detail in *Securities Law and the UCC*, note 135 *supra*.

It appears that no new no-action letters have been requested since September 2000, which may indicate that (i) secured parties are using the more flexible strict foreclosure process provided in Section 9-620 (which unlike Former Section 9-505 clearly permits partial strict foreclosures with retention of a deficiency claim as well as strict foreclosures with respect to collateral not in the possession of the secured party), or (ii) the body of no-action letters that exists has become so standardized that secured parties are comfortable following the exiting precedents rather than obtaining their own no-action letter.

<sup>150</sup> *TM Pacifica Tam O’Shanter, Ltd.*, 1987 SEC No-Act. LEXIS 1603 (Feb. 17, 1987).

<sup>151</sup> *Cavanagh Communities Corp.*, 1981 SEC No-Act. LEXIS 3351 (Apr. 3, 1981).

<sup>152</sup> Thanks to the many people who provided assistance, comments and advice in the process of preparing these materials and in particular thanks to Eva-Marie Nye, Manager of Library Services in the Pillsbury DC office, for her support.

## EXHIBIT A

### SAMPLE IRREVOCABLE PROXY RELATING TO ARTICLE 8 MATTERS<sup>153</sup>

#### IRREVOCABLE PROXY

This Irrevocable Proxy Agreement (this “**Agreement**”) is made as of [date], by and among [insert name of Pledgor], a \_\_\_\_\_ (“**Pledgor**”), [insert name of Issuer of the Pledged Interests], a [state of formation] [limited liability company] [partnership] (the “**Company**”), and [insert name of Secured Party], a \_\_\_\_\_ (“**Secured Party**”).

WHEREAS, the Pledgor is the beneficial and record holder of the [membership/partnership interests] in the Company set forth on Schedule 1 hereto (the “**Pledged Interests**”); and

WHEREAS, Pledgor desires to grant to Secured Party the proxy granted pursuant hereto; and

WHEREAS, Pledgor and Secured Party intend that the proxy granted pursuant hereto be irrevocable during the term of this Agreement and that the powers and proxies granted pursuant to this Agreement are given to secure the obligations of Pledgor under that certain [Pledge Agreement, dated as of [date] between Pledgor and Secured Party] (the “**Pledge Agreement**”);

NOW, THEREFORE, in consideration of the mutual promises and covenants herein contained, and other consideration, the receipt and adequacy of which is hereby acknowledged, the parties hereto agree as follows:

**1. Irrevocable Proxy.** Pledgor hereby irrevocably constitutes and appoints Secured Party, from the date of this Agreement until the termination of this Agreement in accordance with its terms, as Pledgor’s true and lawful proxy, for and in Pledgor’s name, place and stead to vote the Pledged Interests and any and all other equity interests in Company owned by Pledgor, whether directly or indirectly, beneficially or of record, now owned or hereafter acquired (the Pledged Interests together with all such other equity interests, the “**Pledgor’s Interests**”), with respect to any Article 8 Matter (as hereinafter defined). The foregoing proxy shall include the right to sign Pledgor’s name (as [member/partner] of the Company) to any consent, certificate or other document relating to the Company that applicable law may permit or require, to cause the Pledgor’s Interests to be voted in accordance with the preceding sentence. Pledgor hereby revokes all other proxies and powers of attorney with respect to the Pledgor’s Interests that Pledgor may have appointed or granted, to the extent such proxies or powers extend to any Article 8 Matter. Pledgor will not give a subsequent proxy or power of attorney (and if given, will not be effective) or enter into any other voting agreement with respect to the Pledgor’s Interests with respect to any Article 8 Matter.

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<sup>153</sup> **Exhibit A** is only an example; for a specific transaction the language should be tailored to the specific interest and any applicable state laws (including those limiting the use, duration or effectiveness of proxies).

As used herein, “**Article 8 Matter**” means any action, decision, determination or election by the Company or its [member(s)/partners] that its [membership/partnership] interests or other equity interests, or any of them, be, or cease to be, a “security” as defined in and governed by Article 8 of the Uniform Commercial Code, and all other matters related to any such action, decision, determination or election.

THE PROXIES AND POWERS GRANTED BY PLEDGOR PURSUANT TO THIS AGREEMENT ARE COUPLED WITH AN INTEREST AND ARE GIVEN TO SECURE THE PERFORMANCE OF THE PLEDGOR’S OBLIGATIONS UNDER THE PLEDGE AGREEMENT AND UNDER THIS AGREEMENT.

**2. Agreements of Company.** Company shall give copies of any notices or other communications that it sends to Pledgor or to any other [members/partners] of Company related to any Article 8 Matter to Secured Party at the same time as such notices or other communications are sent to Pledgor or any such other [member/partners] of Company. Company acknowledges the powers and proxies granted herein and agrees that Secured Party shall have the sole right during the term of this Agreement to vote the Pledgor’s Interests with respect to any Article 8 Matter.

**3. Termination.** This Agreement shall terminate at such time Company shall have received written notice from Secured Party of the termination of this Agreement.

**4. Restrictive Legend.** Each certificate, if any, representing any of the Pledgor’s Interests shall be marked by Company with a legend reading as follows:

“THE [MEMBERSHIP/PARTNERSHIP] INTERESTS EVIDENCED HEREBY ARE SUBJECT TO AN IRREVOCABLE PROXY AGREEMENT (A COPY OF WHICH MAY BE OBTAINED FROM THE ISSUER) AND BY ACCEPTING ANY INTEREST IN SUCH MEMBERSHIP INTERESTS THE PERSON HOLDING SUCH INTEREST SHALL BE DEEMED TO AGREE TO AND SHALL BECOME BOUND BY ALL THE PROVISIONS OF SUCH AGREEMENT.”

The Company agrees that, during the term of this Agreement, it will not remove, and will not permit to be removed (upon registration of transfer, reissuance or otherwise), the legend from any such certificate and will place or cause to be placed the legend on any new certificate issued to represent the Pledgor’s Interests theretofore represented by a certificate carrying a legend.

**4. Miscellaneous.**

Notices. All notices and other communications required or permitted hereunder shall be in writing and shall be mailed by registered or certified mail, postage prepaid, sent by facsimile or electronic mail or otherwise delivered by hand or by messenger addressed:

If to Pledgor: [address]

If to Secured Party: [address]

If to Company: [address]

Any party may change its address by notice to the other parties given in accordance with the provisions of this paragraph.

Governing Law. This Agreement and all acts and transactions pursuant hereto shall be governed, construed and interpreted in accordance with the laws of the State of [state] as they apply to contracts entered into and wholly to be performed within such state by residents thereof.

Amendment. Except as expressly provided herein, neither this Agreement nor any term hereof may be amended, waived, discharged or terminated other than by a written instrument referencing this Agreement and signed by each of the parties to this Agreement.

Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be enforceable against the parties actually executing such counterparts, and all of which together shall constitute one instrument.

Jurisdiction; Venue. With respect to any disputes arising out of or related to this Agreement, the parties consent to the exclusive jurisdiction of, and venue in, the state or federal courts located within the State of [state].

The parties have executed this Agreement as of the date first above written.

**[COMPANY]**

By:

**[PLEDGOR]**

By:

**[SECURED PARTY]**

By:

Attachment: Schedule 1 [describing Pledged Interests]

## EXHIBIT B

### SAMPLE SECURITY AGREEMENT LANGUAGE RELATING TO DISPOSITION OF COLLATERAL AND SECURITIES LAWS MATTERS<sup>154</sup>

The Pledgor recognizes that the Lender may be unable to effect a public sale of all or a part of the Collateral by reason of certain prohibitions contained in the Securities Act of 1933, as amended (the “**1933 Act**”), or other relevant securities laws in any jurisdiction, and may be compelled to resort to one or more private sales to a restricted group of purchasers (or to a single purchaser) who will be obligated to agree, among other things, to acquire the Collateral for their own account, for investment and not with a view to the distribution or resale thereof. The Pledgor acknowledges that private sales so made may be at prices and on other terms less favorable to the seller than if the Collateral were sold at public sale, and that the Lender has no obligation to delay the sale of any Collateral for the period of time necessary to permit the registration of the Collateral for public sale under the 1933 Act or other relevant securities laws in any jurisdictions or to qualify for any other exemption from registration under the 1933 Act or other relevant securities law or to sell the collateral in more than one transaction to qualify for any such exemption. The Pledgor agrees that a private sale or sales made under the foregoing circumstances shall not be deemed to be commercially unreasonable by virtue of such circumstances.

If any consent, approval or authorization of, or filing with, any governmental authority or any other Person is necessary to effect any disposition of the Collateral, including, without limitation, under any federal or state securities laws, the Pledgor agrees to execute all such applications, registrations and other documents and instruments as may be required in connection with securing any such consent, approval or authorization, and will otherwise use commercially reasonable efforts to secure the same. The Pledgor further agrees to use its best efforts to effectuate such sale, or other disposition of the Collateral, as the Lender may deem necessary or desirable pursuant to the terms of this Agreement.

Notwithstanding any other provision of the loan documents or any other obligation of the Lender, in connection with any disposition of the Collateral the Lender may disclose to prospective purchasers all of the information relating to the Collateral (and the issuer thereof) that is in the Lender’s possession or otherwise available to the Lender.

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<sup>154</sup> **Exhibit B** is only an example; for a specific transaction the language should be tailored to the specific interest. For example, the language might be modified to deal with (i) state securities laws, (ii) limitations on manner of sale or eligible purchasers relating to exemptions from the 1940 Act, the 1934 Act, ERISA or being a taxable entity, and (iii) limitations on who can own the pledged interests established by the entity governing documents, applicable regulatory regimes (*e.g.* U.S. federal statutes requiring that ownership or control of certain types of business be limited to U.S. citizens or other qualified owners) or the transaction document (*e.g.* the “qualified transferee” restrictions found in real estate mezzanine financing intercreditor agreements).



## EXHIBIT C

### FURTHER DISCUSSION OF *BURNS v. ANDERSON*

#### Summary of Facts

The pledged stock was "thinly traded stock registered on the NASDAQ."

The pledge agreement:

- provided that the collateral could be sold in a private sale (upon such terms and conditions as secured party deemed advisable) and that secured party could purchase the collateral at any sale; and
- contained an acknowledgment by the pledgors that the pledged stock was "of a type customarily sold on a recognized market, in each case within the meaning of [Section 9-610]."
- included the following provision:

Pledgor[s] further recognize[] that the market for the Pledged Stock is illiquid and that a public sale of the Pledged Stock in a significant quantity could have an adverse effect on the market price for the Pledged Stock. Therefore, Pledgor[s] acknowledge[] and agree[] that . . . no private sale of the Pledged Stock (whether such sale is to the Pledgee [i.e. secured party] or to a third party) will be deemed to have been made in a commercially unreasonable manner for the reason that it was made at a price that reflects a discount from the then current market price of such Pledged Stock. Pledgor[s] further acknowledge[] and agree[] that, to the fullest extent permitted by applicable law, any such discount that is calculated in accordance with an appraisal of the Pledged Stock by an independent appraiser . . . shall be deemed to be commercially reasonable. [emphasis and deletions in original]

Following a payment default, the secured party sent a notice of default and a "Notification of Disposition of Collateral."

- the Notification of Disposition of Collateral stated that the secured party would effect a private sale of all or a portion of the pledged stock "sometime after" a specified date.

The secured party hired an independent appraiser to issue a report on the value of the pledged stock.

The secured party had the pledged stock transferred into his name, credited the appraised value of the pledged stock against the loan balance and brought suit for the deficiency.

The trial court held that the secured party had properly exercised his rights to the collateral in accordance with Section 9-610 and that the appraisal was commercially reasonable, and entered a judgment for the deficiency.

On appeal, the pledgors argued that the secured party failed to dispose of the pledged stock in accordance with Section 9-610.

- the pledgors argued that the secured party did not purchase at a private disposition under Section 9-610, because there were no "traditional indicia of a sale" (e.g. solicitation,

negotiation and the presence of a buyer and seller whose interests with respect to the price are at odds).

- the appellate court (rightly) rejected this limited view of what would constitute a “private disposition” under Section 9-610.
- the appellate court stated that:
  - Section 9-601(a) recognizes that the rights of a secured party are “those rights provided in [Part 6 of Article 9] and . . . those provided by agreement of the parties;”
  - that the foreclosure by the secured party “followed precisely the sale method with respect to the [pledged stock] afforded to [the secured party] and agreed to by the parties under the Pledge Agreement;”
  - the time, place and terms of the secured party’s purchase of the pledged stock were commercially reasonable as required by Section 9-610;
  - except for the requirement of commercial reasonableness, the time, place and terms of a disposition of collateral are not constrained by the UCC; and
  - the pledged stock met the requirement of being a type of collateral customarily sold on a recognized market.
- the appellate court also stated that permitting the secured party to purchase in this manner did not “eviscerate any distinction” between a private disposition under Section 9-610 and retention of collateral under Section 9-620.
  - the court stated that “[t]he [secured party] proposal and [debtor] consent prerequisites to retaining collateral in satisfaction of all or a portion of the debt under [S]ection 9-620 protect a debtor from any commercially unreasonable determination of the value of the collateral and corresponding prejudicial reduction of the debt, whereas [S]ection 9-610 affords a debtor the protection of the commercial reasonableness standard. Because the disposition of the [pledged stock] was commercially reasonable, the [pledgers] cannot establish that they were prejudiced in any way by [secured party]’s election to dispose of the [pledged stock] under [S]ection 9-610 rather than to retain it under [S]ection 9-620.”
- the appellate court acknowledged (in its evaluation of whether to accept the appraiser’s testimony as to the value of the stock) that “the potential rate of error in conducting a valuation may be large, and differences in valuation opinions may be great.”
- the appellate court found that the secured party had used the stock sale method provided for in the pledge agreement (*i.e.* appraised value) and that therefore the sale was commercially reasonable and the requirements of Section 9-610 were satisfied.

Pledgers appear not to have argued that it was inappropriate to use the appraisal price (rather than the market price) when relying on the recognized market exception that allows a secured party to buy at a private sale.

## Discussion of Relevant Provisions of UCC Article 9

Section 9-601(a) provides that after default, a secured party has the rights provided in Part 6 of Article 9 and, except as otherwise provided in Section 9-602, those provided by agreement of the parties. Section 9-602 specifies rights of a debtor or obligor, and duties of the secured party, that are provided by Article 9 that may not be waived or varied by the debtor or the obligor.<sup>155</sup>

Section 9-610 permits a secured party to dispose of any or all of its collateral after default. Every aspect of a disposition of collateral (including the method, manner, time, place and other terms) must be commercially reasonable. If commercially reasonable, a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels and at any time or place and on any terms.<sup>156</sup>

Section 9-610(c) provides that a secured party may purchase collateral:

- (1) at a public disposition<sup>157</sup> or
- (2) at a private disposition only if the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations.<sup>158</sup>

A “**recognized market**” is one in which the items sold are fungible and prices are not subject to individual negotiation (*e.g.* the New York Stock Exchange). A market in which prices are individually negotiated or the items are not fungible is not a recognized market, even if the items are the subject of widely disseminated price guides or are disposed of through dealer auctions. *See* Official Comment 9 to Section 9-610; *see also* Official Comment 4 to Section 9-627.

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<sup>155</sup> In addition, Section 1-102(3)(Revised Section 1-302) addresses UCC provisions that may not be varied by agreement. *See* Official Comment 2 to Section 9-602.

<sup>156</sup> Section 9-610(a) and (b). Former Section 9-504 contained comparable provisions.

<sup>157</sup> The term “**public disposition**” is not defined in Article 9; Official Comment 7 to Section 9-610 states that for purposes of Article 9 a public disposition “is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. ‘Meaningful opportunity’ is meant to imply that some form of advertisement or public notice must precede the sale (or other disposition) and that the public must have access to the sale (disposition).”

As discussed in Official Comment 7 to Section 9-610, Part 6 of Article 9 makes only two distinctions between “public” and other dispositions: (i) the secured party’s ability to purchase at a non-public disposition is subject to limitations (as provided in Section 9-610(c)), and (ii) the debtor is entitled to notification of “the time and place of a public disposition” and notification of “the time after which” a private disposition or other intended disposition is to be made (as provided in Section 9-613(1)(E)). Article 9 does not retain the distinction under Former Section 9-504(4), under which transferees in a noncomplying public disposition could lose protection more easily than transferees in other noncomplying dispositions; instead Section 9-617(b) adopts a unitary standard. *See also* Official Comment 3 to Section 9-617.

<sup>158</sup> Former Section 9-504 contained comparable provisions.

In addition (i) a secured party may purchase at an execution sale, *see* Section 9-601(f) and Official Comment 8 to Section 9-601, and (ii) if a security agreement covers both real and personal property a secured party may proceed as to both in accordance with the rights with respect to real property, *see* Section 9-604(a)(2) and Official Comment 2 to Section 9-604.

Section 9-610(c) is not one of the provisions of Article 9 that Section 9-602 expressly provides cannot be waived or varied by agreement of the parties. However, Official Comment 2 to Section 9-624 states “transactions [in which a secured party buys at its own private disposition] are equivalent to ‘strict foreclosures’ and are governed by Sections 9-620, 9-621, and 9-622,” and Sections 9-602(10) and 9-624 provide that (with a limited exception in consumer transactions) the provisions of Sections 9-620, 9-621 and 9-622 cannot be altered by agreement of the parties. As a result, Section 9-610(c) should be treated as a provision that the parties cannot waive or vary by agreement.

Section 9-603(a) provides that the parties may determine by agreement the standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party under a rule stated in Section 9-602 if the standards are not manifestly unreasonable. *See also* Official Comment 2 to 9-603.

Section 9-627(b) states that “[a] disposition of collateral is made in a commercially reasonable manner if the disposition is made: (1) in the usual manner on any recognized market; (2) at the price current in any recognized market at the time of the disposition; or (3) otherwise in conformity with reasonable practices among dealers in the type of property that was the subject of the disposition.” Section 9-627 can be altered by agreement of the parties. *See* Sections 9-602, 9-624.

## Issues

Interpretation of the “of a kind . . . customarily sold on a recognized market” exception to the prohibition of a secured party’s purchase of collateral at a private sale.

- does Section 9-610(c)(2) require, for the protection of debtor’s interest, that the secured party’s purchase at a private disposition be at the market price (as determined by a recognized market) or standard price quote?
- if the collateral is traded on a recognized market, and the parties agreed that using an appraisal was a commercially reasonable method of determining the value of the collateral, why isn’t that sufficient (*i.e.* is *Burns* wrongly decided on this issue?) – Section 9-610(c)(2) requires that the collateral be of a kind customarily sold on a recognized market or the subject of standard price quotations, but does not contain an express requirement that the secured party purchase at the price established by such recognized market or standard quotations.
- a sale by the secured party to an unrelated third party at a private sale using the appraised value might have been upheld as commercially reasonable (depending on the facts and circumstances of the disposition) – what is different if the secured party buys at that same value?
- sale of a large enough block could disrupt market price – is it equitable to require the secured party to credit bid at a price it cannot obtain if it sold into the market?
- sale of a large enough block may merit a “control premium” over the market price – is it equitable to permit the secured party to credit bid at the lower market price?
- how does the Article 1 requirement of good faith apply?

- if the block is large enough to disrupt the market or price quotes, is the collateral no longer “of a kind” customarily sold on a recognized market or the subject of widely distributed standard price quotations?
- can the parties agree that the relevant market is a “recognized market” or is that a determination for a court?
- in *Burns*, the pledgors did not submit any evidence on the value of the stock (only challenged the valuation obtained and used by the secured party) – can the case be viewed as a disguised “no harm to the pledgors” holding?

Official Comment 2 to Section 9-624 states that the secured party’s purchase at a private sale is the equivalent of retention of the collateral to which Sections 9-620, 9-621 and 9-622 (which Sections 9-602(10) and 9-624 do not permit to be waived or varied by agreement of the parties) applies.

- while not expressly stated, this should only apply if the secured party attempts to buy at a private sale to which Section 9-610(c)(2) does not apply.

Should the pledgors have made a claim under Section 9-615(f) (method for calculating a deficiency or surplus if (i) the transferee in the disposition is the secured party, a person related to the secured party or a secondary obligor, and (ii) the amount of proceeds of the disposition is significantly below the range of proceeds that a complying disposition to a person other than the secured party, a person related to the secured party or a secondary obligor would have brought)?<sup>159</sup>

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<sup>159</sup> See also Official Comment 6 to Section 9-615 and Official Comment 10 to Section 9-610.

**EXHIBIT D**  
**OPT IN AND PROCEEDS UNDER**  
**FORMER ARTICLES 8 AND 9**  
**(A DIGRESSION INTO HISTORICAL MATTERS)**

With Article 9's broader definition of proceeds an opt in is no longer needed to deal with the limits in the Former Article 9 definitions of proceeds or the related issue under Bankruptcy Code Section 552.

Former Article 9's limited definition of "proceeds" raised perfection and bankruptcy issues that an opt in might solve. In *FDIC v. Hastie (In re Hastie)*, 2 F.3d 1042 (10<sup>th</sup> Cir. 1993), a bankrupt debtor received cash dividends on pledged stock, in which the secured party claimed a perfected security interest. The court held that ordinary dividends on corporate stock were not "proceeds" of the stock (at the time of the *Hastie* case, Former Section 9-306(1) provided that proceeds were "whatever is received upon a sale, exchange, collection or other disposition of the collateral or proceeds"), that the security interest in the dividends was not perfected by possession of the stock certificates and that because the secured party did not have a perfected security interest in the post-petition dividends the debtor (as a hypothetical lien creditor under Bankruptcy Code Section 544) could avoid the security interest.

In *In re Mintz*, 192 B.R. 313 (Bankr. D. Mass. 1996) the secured party had a security interest in rights to distributions from a partnership. The court held that payments of the distributions were not proceeds of the right to receive the distributions and that under Bankruptcy Code Section 552(a) a security interest in the distributions would be cut off with respect to distributions payable following the filing of the debtor's bankruptcy. Bankruptcy Code Section 552(a) provides that property acquired by the debtor after the commencement of the debtor's bankruptcy proceeding is not subject to a security interest resulting from a security agreement entered into by the debtor before the commencement of the case; Bankruptcy Code Section 552(b) creates an exception to this general rule, providing that if the security interest created by a security agreement entered into prior to the commencement of the case extends to property of the debtor acquired before commencement of the case and to proceeds of such property, then such security interest extends to such proceeds acquired by the debtor after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, based on the equities of the case, orders otherwise.

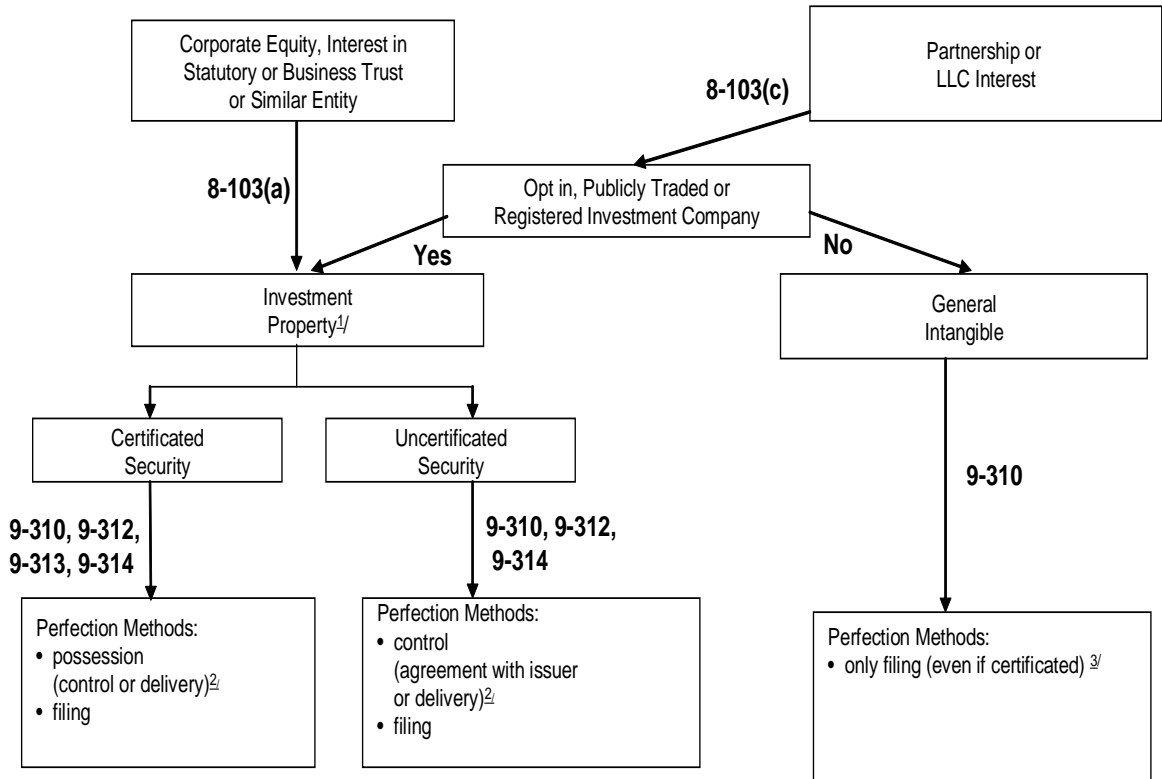
The 1994 revisions to Article 8 modified the definition of proceeds in Former Section 9-306(1) to remove the issues raised by the *Hastie* case (by adding that any payments or distributions made with respect to investment property collateral (including securities) were proceeds). The 1994 revisions did not, however, remove the issues raised by the *Mintz* case (or similar issues that could arise even if the LLC or partnership interest itself had been pledged) since the addition to the definition of proceeds was limited to payments or distributions in respect of investment property (which, in the absence of an opt in, generally would not include an LLC or partnership interest). Therefore, under Former Article 9 secured parties required an opt in for LLC or partnership interests as collateral to bring the distributions in respect of those interests within the Former Article 9 definition of proceeds (as modified by the 1994 revisions to Article 8). Although it was not certain that the opt in would solve the issue under Bankruptcy Code Section 552, it at least provided an argument that the distributions in respect of LLC and partnership

interests were proceeds of the interests within the meaning of Section 552(b) and therefore not subject to the cut off of security interests rule in Section 552(a). The Article 9 treatment of the distributions is not dispositive of whether the distributions are proceeds for purposes of Bankruptcy Code Section 552, but has often been a factor considered by courts in the Section 552 analysis.

Section 9-102(a)(64) defines proceeds to include “whatever is collected on, or distributed on account of, collateral” (*i.e.* the distributions will be proceeds for Article 9 purposes, regardless of the collateral type of the LLC or partnership interest). *See also* Official Comment 13(a) to Section 9-102.

**EXHIBIT E**

# Methods of Perfection



<sup>1/</sup> An equity interest held in a securities account would be a “security entitlement” as to which perfection methods are control and filing. See 9-310, 9-312, 9-314.

<sup>2/</sup> The concepts of “control” in 8-106 and “delivery” in 8-301 are used in Article 9. See 9-106, 9-313(a).

<sup>3/</sup> If the interest can be categorized as a payment intangible, then a sale of the interest would be automatically perfected. See 9-309(3).

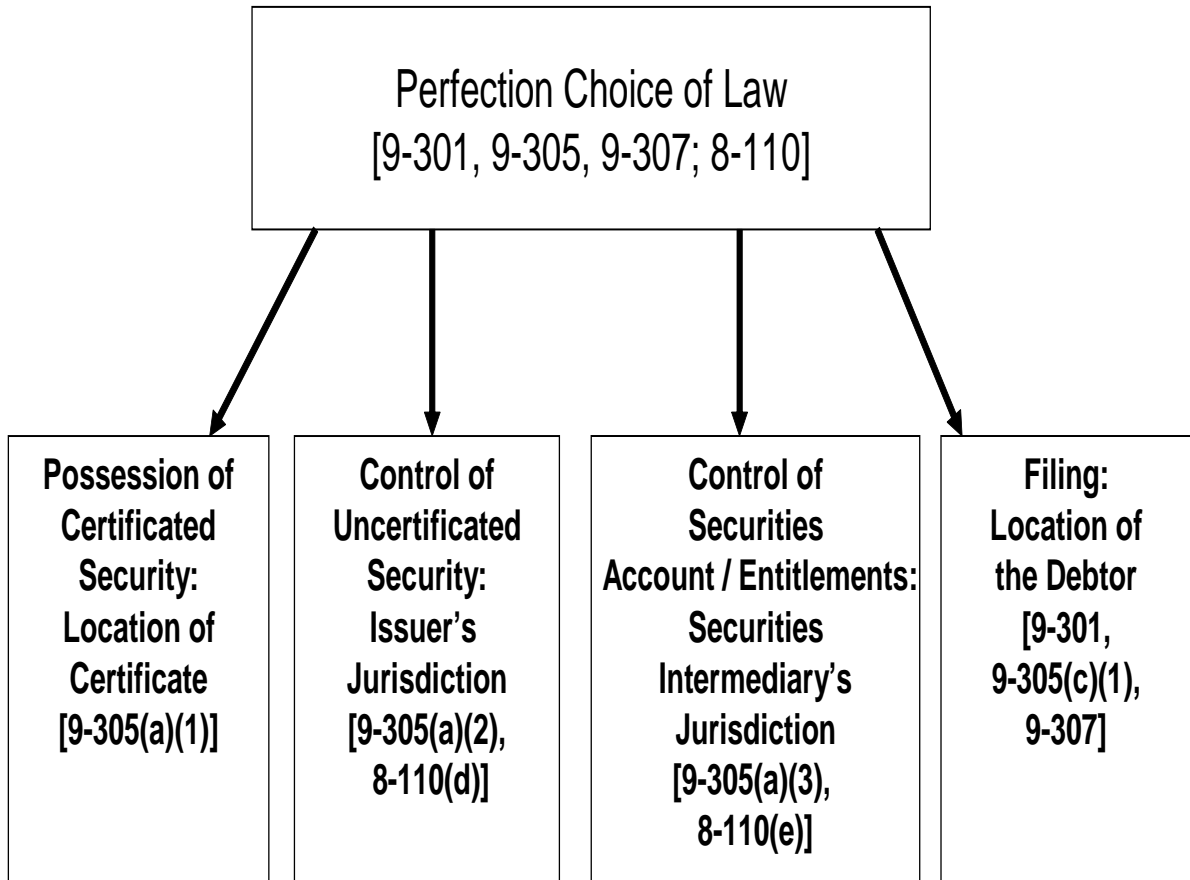
Automatic perfection is also applicable to security interests in investment property created by a broker or securities intermediary. See 9-309(10).

Other automatic and temporary perfection rules can be found in 9-309(9), 9-312(e) and (g).



**EXHIBIT F**

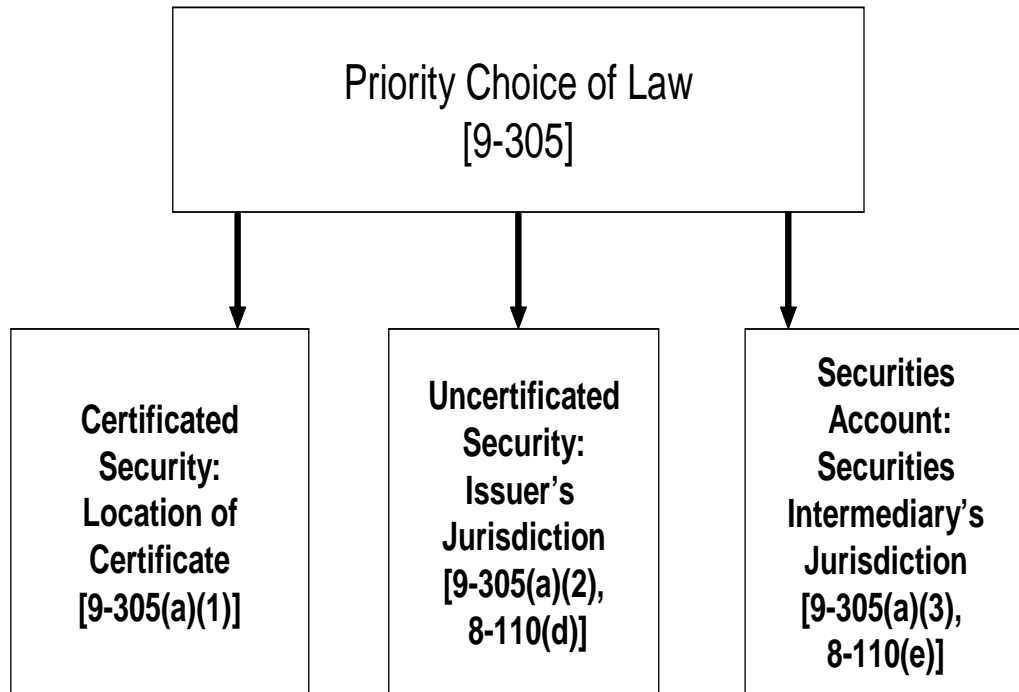
# Perfection Choice of Law



**Note: See 9-305 re automatic and temporary perfection choice of law.**

**EXHIBIT G**

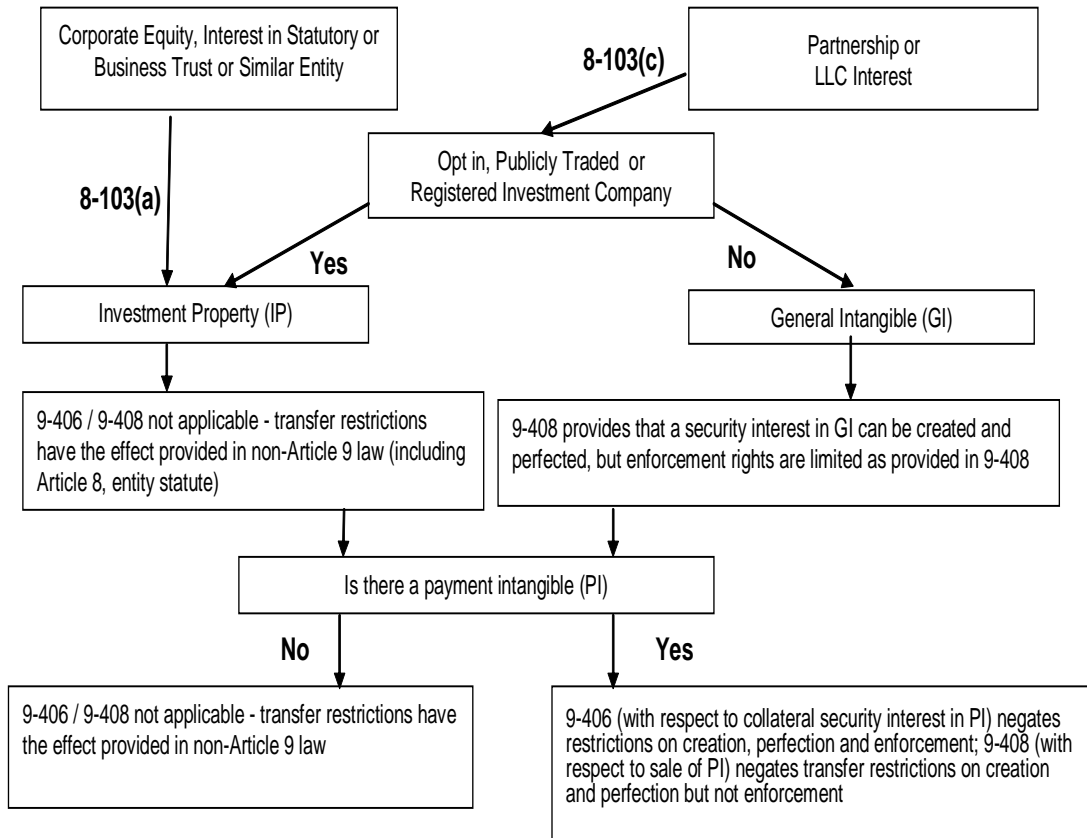
# Priority Choice of Law



**Note: Perfection method not relevant to priority choice of law.**

EXHIBIT H

# Negation of Restrictions on Assignment



See notes on next slide.

# Negation Analysis - Notes

- 1) Certification of interest not relevant to determination of whether interest is a general intangible or investment property. An LLC or partnership interest or other investment property held in a securities account would be a “security entitlement” (with same analysis as other investment property).
- 2) Delaware, Virginia, Kentucky and Texas have non-uniform UCC provisions and/or provisions in LLC and partnership statutes that make 9-406/9-408 inapplicable to partnership and LLC interests. Delaware also deals with statutory trusts in same manner. NY and other states 9-406/9-408 do not negate statutory restrictions on assignment. See 9-401 OC3 regarding choice of law applicable to 9-406/9-408 negation of transfer restrictions – likely to be jurisdiction of organization of the issuer of the pledged interest.
- 3) Only transfer restrictions in an agreement between the debtor and the “account debtor” are negated; examine LLC or partnership agreement and state law as to who are the parties to the agreement with the debtor (*i.e.* pledging member or partner) and consider who the “account debtor” is for this purpose (issuer or other equity holders).
- 4) Consider whether (and when) a right to a distribution could become a PI separate from the IP or GI. Also consider Bankruptcy Code § 552 and similar issues if only distributions are collateral.
- 5) Consider whether the equity interest itself may be categorized (in whole or in part) as a PI.