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You're What You Own: Perfection of Security Interests in Investment Property

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Under Article 9 of the Uniform Commercial Code (?UCC?), a secured party perfects its security interest in investment property ? such as certificated and uncertificated securities, securities accounts and commodity accounts ? by acquiring ?control? over such investment property. In the world of secured lending, control of a security entitlement typically takes the form of a control agreement executed by and among the borrower, the lender and the securities intermediary (broker-dealer, investment house, clearing corporation, etc.) that maintains the security entitlement. The key provision in a control agreement that satisfies the ?control? requirement of the UCC is the agreement by the securities intermediary to comply with entitlement orders, or instructions regarding the security entitlement, directly from the secured party without further consent from the borrower/account holder, so that, as between the secured party and the securities intermediary, the secured party becomes the entitlement holder.

The traditional transaction looks something like the following: a borrower executes a security agreement in favor of its lender, granting a security interest in an investment account as collateral for a loan, and the securities intermediary executes a control agreement submitted by the lender (or sometimes substitutes its own in-house form) to perfect the lender?s security interest. As long as no event of default occurs, the borrower may manage the investment account as it sees fit, subject to any minimum balance requirements or other constraints of the applicable security agreement or related loan documents. But, upon the occurrence of an event of default, the lender will deliver one or more entitlement orders to the securities intermediary, from and after which time the securities intermediary will comply with instructions regarding the account solely from the lender. What happens, though, if the securities intermediary refuses to sign a control agreement?

In case of *Fifth Third Bank v. Lincoln Financial Securities Corp.*, the court imposed liability on Lincoln (the securities intermediary) for two critical breaches of the underlying control agreement: making false representations regarding the value of the account and selling securities out of the account to reimburse itself after the account owner?s check, which was used to purchase the securities in the account, bounced. Interestingly, the provisions of the control agreement at issue in *Lincoln* fell far outside the

parameters of the ordinary commercial marketplace; securities intermediaries should not be asked to warrant account values or prohibited from imposing liens to secure payment for the securities in the account. However, despite these anomalies, the *Lincoln* ruling has left some securities intermediaries reluctant to sign control agreements at all in order to mitigate their risk ? after all, signing a control agreement ultimately provides no benefit to the securities intermediary, but is rather a customer service accommodation for its client.

When faced with a securities intermediary reluctant to sign a control agreement, there is another way for a lender to become the entitlement holder of a security entitlement for UCC purposes. The lender can become the entitlement holder, either holding through the same securities intermediary that the borrower used or having the securities position transferred to its own securities intermediary. Though perhaps less desirable to borrowers, since they will no longer be the record owners of the property from the outset (despite retaining beneficial ownership), this tactic offers a useful alternative to the standard control agreement practice. To effectuate the lender?s ownership of the account, the lender and borrower would need to execute the appropriate paperwork with the securities intermediary (such as new account forms) to show the lender as owner. The lender could also suggest titling the account in a way that reflects its ownership of the account (for instance, [Lender] Collateral FBO [Borrower]) and listing the lender?s contact information as the address of record for the account. These measures ? together with any other specific steps recommended by the securities intermediary ? will prevent the borrower from trading the securities without the lender?s consent. In addition, the lender should ensure that the security agreement appropriately describes the lender?s property interest in the account as an ownership interest rather than merely a security interest. The lender may want to consider filing a UCC-1 financing statement against the borrower with respect to the securities entitlement; though filing is not the preferred method to perfect a security interest in investment property (since perfection by control will take priority over perfection by filing under the UCC), it remains a prudent measure and will serve as a prophylactic notice to third parties. Finally, for belt-and-suspenders protection, the lender should send a written letter of instruction to the securities intermediary, clarifying that the lender is the record owner of the account and that the borrower may not trade on the account without the authorization of the lender. Even if this correspondence is not counter-signed by the securities intermediary, it will serve to further clarify the rights and responsibilities of the parties with respect to the investment property.

The two principal ways for a secured lender to cut off other creditors of its borrower with respect to a security entitlement: by having a control agreement from the securities intermediary with respect to the property, or by actually becoming the entitlement holder. By following the steps outlined herein, a lender will effectively ensure that its borrower cannot act unilaterally with respect to the investment property collateral, thus satisfying the ?control? test for UCC purposes.

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