KEY CONSIDERATIONS FOR SECURED LENDERS

Insured Cash Sweeps as collateral

Introduction

The aftermath of several US bank failures in early 2023 gave rise to a wave of corporate treasury diversification initiatives, including the proliferation of certain previously obscure bank products known as “Insured Cash Sweeps” (ICS) and “Certificate of Deposit Account Registry Service” (CDARS).

Depositors use these products to spread their cash across several accounts at different banks, which mitigates the risk of a deposit bank failure by (a) diversifying funds among unrelated financial institutions and (b) extending Federal Deposit Insurance Corporation (FDIC) insurance coverage above the $250,000 cap at any one institution.

Finance professionals, lawyers, advisors of corporate depositors, and the like are encouraged to understand how these bank products are structured and operate. Lenders, who previously may have held 100 percent of a client’s cash “on the balance sheet,” should be particularly aware of the nuances involved in properly establishing and maintaining their security interests in these types of “off balance sheet” products.

This handbook will introduce the ICS and CDARS bank products and explain how they are structured, exploring some of their unique intricacies along the way. It will also discuss some ways in which secured transactions and creditors’ rights are implicated, concluding with a few recommendations for lenders seeking to maintain proper attachment and perfection on corporate/borrower Cash Sweep accounts.

Insured Cash Sweeps: How they work

ICS, CDARS, and other similar bank products (which are referred to herein, collectively, as Cash Sweeps) are a collection of services offered by certain financial institutions that, by utilizing a network of connected banks, automatically distribute a given depositor's funds across multiple different accounts held at the various networked banks. Given that the $250,000 FDIC insurance limit is, generally speaking, on a "per bank, per account" basis, by sweeping deposited funds in excess of the maximum coverage amount into a series of different accounts at multiple different banking institutions, depositors may have a significantly greater portion of their funds covered by FDIC insurance.

Cash Sweeps effectively circumvent the FDIC maximum insured amount by opening multiple accounts, at multiple banks, each with balances under the FDIC maximum. ICS and CDARS both provide a similar service, with the key distinction being that ICS applies to funds in bank accounts, whereas CDARS is for certificates of deposit (CDs).

Numerous banks have implemented Cash Sweep programs for their customers, by utilizing affiliate banking entities within their greater corporate group, as well as via participation in a larger network of unaffiliated cooperating banks. There are also a number of non-bank companies that, in partnership with such banking networks (or one of their member banks), sell Cash Sweep products and services to the general public. Several such non-bank firms not only offer these products to individuals and companies, but also provide smaller/regional banks with access to their expansive network of depository banks.

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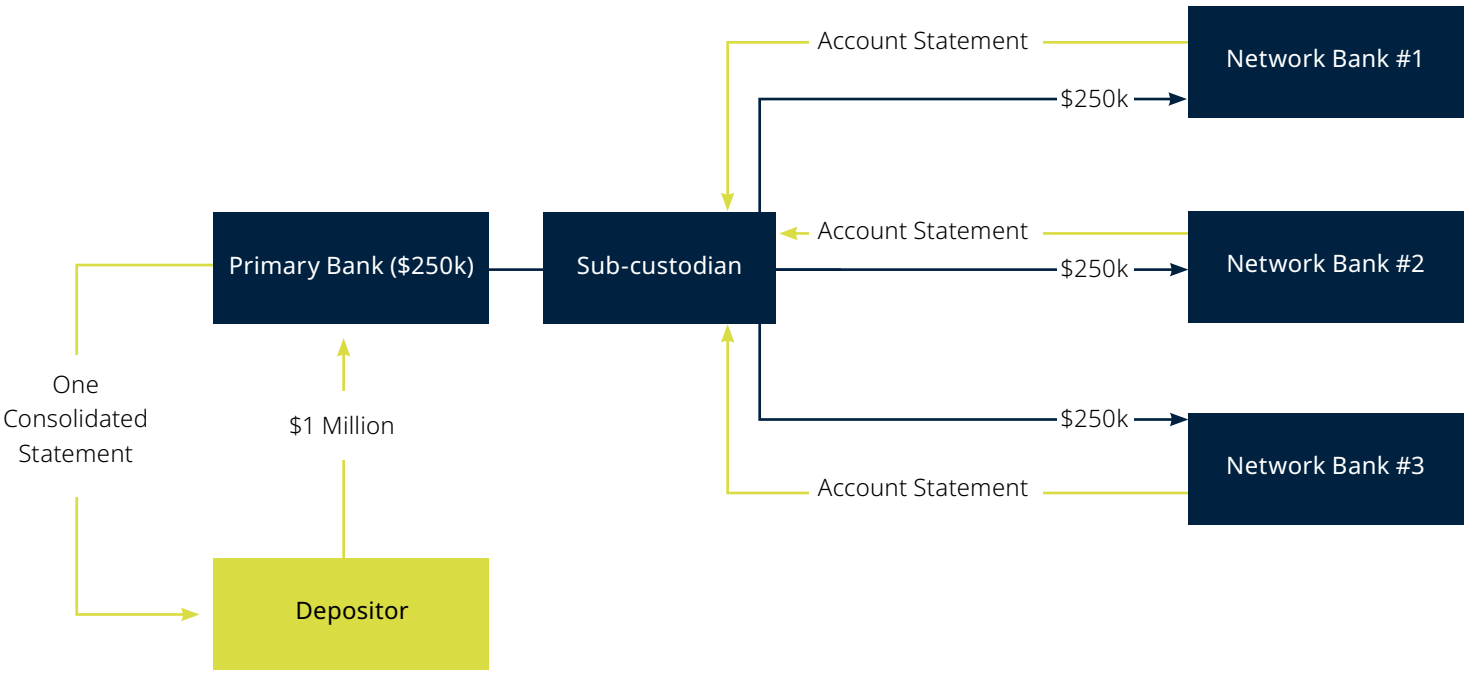
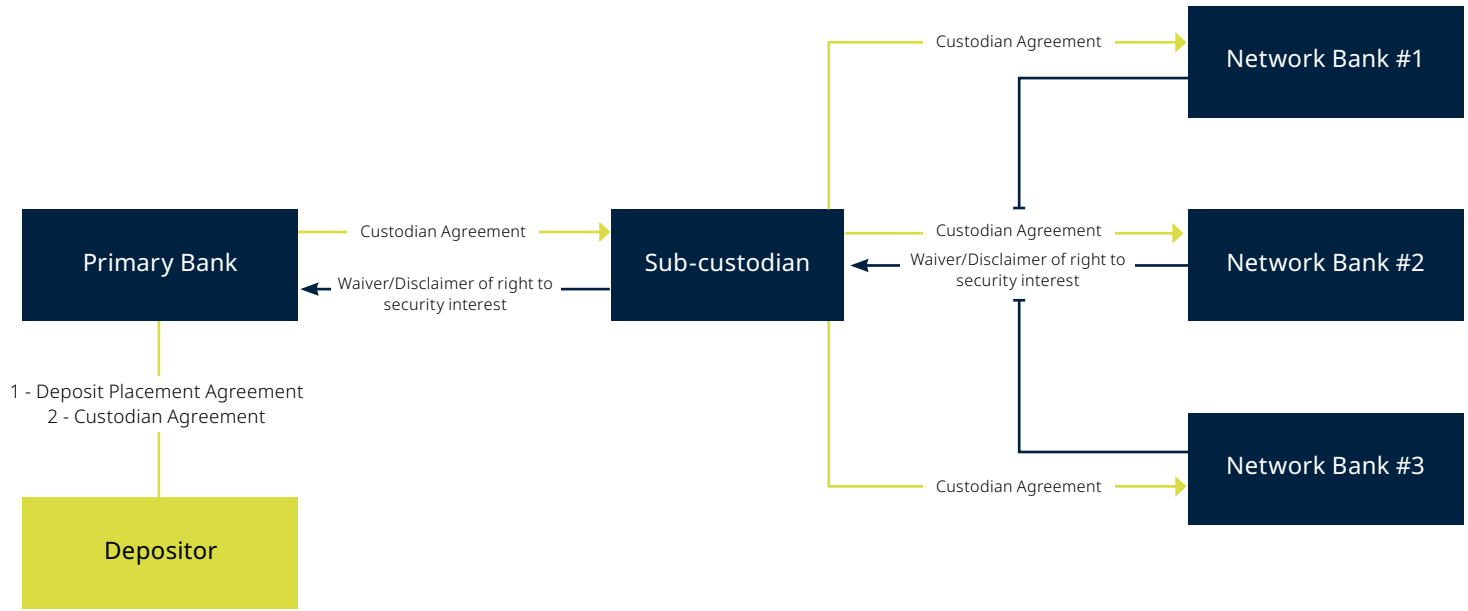
- The primary bank (the entity offering/selling the Cash Sweep product) acts as custodian of the depositor's funds and often uses another bank, which specializes in running the "sweep network," as a sub-custodian. The primary bank generally enters into two agreements with the depositor, one often referred to as a "Deposit Placement Agreement" and the other a "Custodian Agreement."
- The bank administering the sweep operation (usually a sub-custodian, but sometimes the primary bank itself) manages the aggregate custodial accounts held at dozens, or hundreds, of participating network banks, and maintains a ledger of the depositor's sub-balances in each of the various custodial accounts across the many network banks.
- The several sub-custodians usually perform this role for a number of different primary banks, such that the overall grand total of custodial accounts at participating network banks managed by a given sub-custodian includes a large amount of funds from numerous depositors. A primary bank can also be a "participating bank" in the sweep network (*ie*, one that holds depositor funds in its accounts), and many usually are.
- The sub-custodians have formal contracts with each participating bank, whereby they acknowledge that the custodial accounts are being held in a custodial capacity. Each participating bank also agrees to rely on the sub-custodian's ledger of sub-balances to determine the interests of each individual depositor in the aggregate deposits held at that participating bank. These contracts are carefully structured to meet the FDIC rules that permit each sub-balance to be a separate FDIC-insured account in the name of the primary bank's depositor.
- In many of these structures, the primary bank agrees, as part of the Deposit Placement Agreements and Custodial Agreements, to act as a "securities intermediary" under Article 8 of the Uniform Commercial Code (UCC), whereby the depositor's interests in the custodial accounts at the participating network banks are treated as "financial assets" being held in a "securities account" by the primary bank (in its capacity as a "securities intermediary"). As such, the depositor is the owner of "security entitlements" pursuant to UCC Article 8, covering the depositor's interests in the custodial accounts.
- Usually, the primary bank, sub-custodian (if any), and each participating network bank specifically waive and disclaim any right to a security interest or right of set off in the funds held in the custodial accounts. As described in more detail below, this is an important nuance for secured lenders and should be confirmed as lenders are reviewing the underlying Cash Sweep documents.

ICS Network Cash Flow



ICS Network Agreements Flow



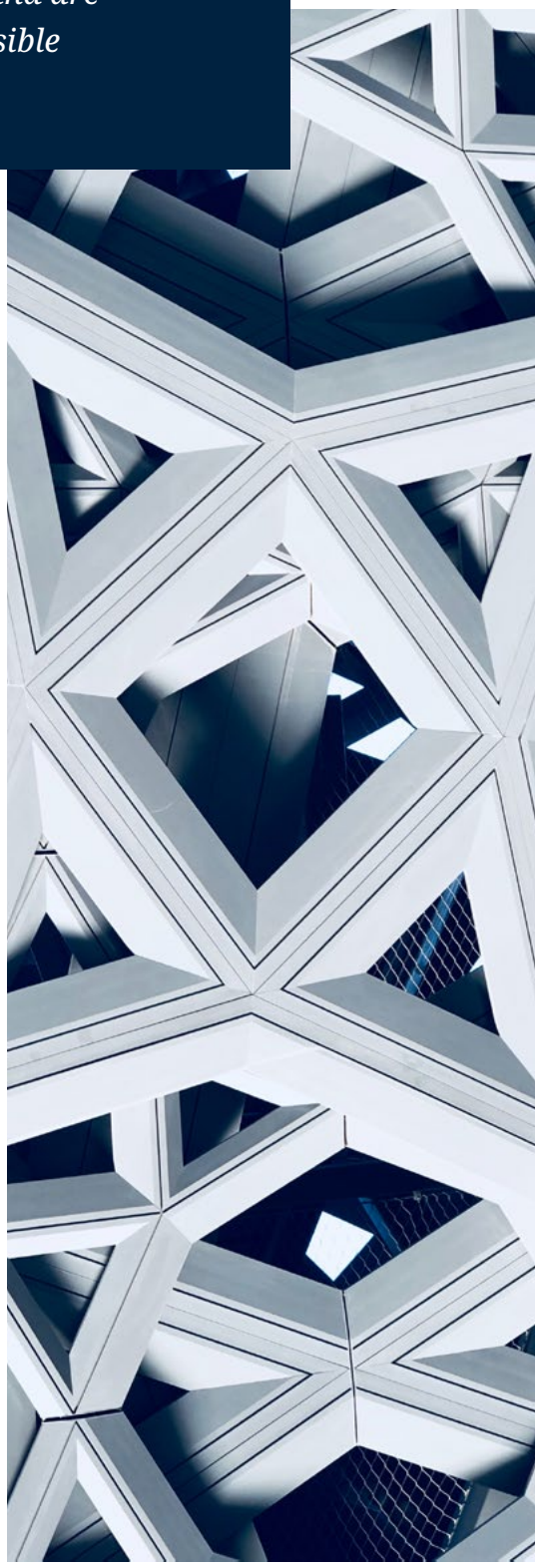
Implications for secured lenders

While Cash Sweep products existed prior to the 2023 bank failures, they have only recently become more prevalent, as the costs of implementing the sweep programs (passed along and charged to the depositors) had previously been seen as too expensive in light of what was then viewed as a de minimis risk of bank failure triggering the FDIC insurance protections. As such, there is very little case law regarding these products and even less concerning the implications for secured transactions and creditors' rights. There is, however, one seminal case, *Monticello Banking Company v Flener*,[1] which helps to shed some light on the issues posed to lenders when the cash of their borrowers is subject to a Cash Sweep.

In *Monticello*, the US Court of Appeals for the Sixth Circuit affirmed the lower court's ruling and, by doing so, provided a legal foundation for a debtor to challenge its broker-dealer's security interest in the debtor's financial assets that the broker held as custodian on behalf of the debtor (as a customer). The court held that, in order to attach a security interest to the debtor's "security entitlement" in their CDARS account (*ie*, the interests in the underlying CDs held at the several network banks), the security agreement between the broker/creditor and its customer/debtor must adequately describe the underlying CDs or the CDARS account through which the CDs are held.

To do so properly, the court explained that the agreement must either (A) describe the CDARS account as a "securities account" or the interests in the underlying CDs held in the CDARS account as "security entitlements" or "investment property" or (B) provide a detailed description of each of the underlying CDs themselves. Further, the court also held that "without an adequate description, [broker/creditor] Monticello cannot have a secured interest through control."

"Lenders seeking to properly obtain a first-priority lien on the assets of a given borrower that are subject to a Cash Sweep (eg, cash deposits, CDs, etc.) should be aware of the potential pitfalls endemic to such collateral and are encouraged to take certain additional steps in order to mitigate possible deficiencies in their security interests."



The security agreement in question for Monticello did not designate the CDARS accounts or their underlying CDs as a "securities account," "security entitlement," or "investment property." Further, while the security agreement did indeed provide a very detailed list of the CDARS accounts (specifying account name, account number, issue date, principal amount, interest rate, and date of maturity for each account), it did not likewise provide a detailed schedule of the underlying CDs. As a result, the court ruled that the CDARS account and the underlying CDs were not adequately described and therefore not covered in the security agreement's definition of collateral, so there was no attachment of the broker's security interest to those assets.

Maintaining a lien on borrower Cash Sweep accounts

Lenders seeking to properly obtain a first-priority lien on the assets of a given borrower that are subject to a Cash Sweep (eg, cash deposits, CDs, etc.) should be aware of the potential pitfalls endemic to such collateral and are encouraged to take certain additional steps in order to mitigate possible deficiencies in their security interests. The following, while not exhaustive, are a few key supplemental actions that lenders should consider.

Attachment: Collateral

For any credit facility in which Cash Sweep accounts are pledged, the collateral description in the facility's loan documents must be sufficient in order for the lender's security interests to "attach" to the Cash Sweep accounts at the primary bank and the borrower's interests in the underlying deposits/CDs held at participating network banks.

Collateral description

In light of the Monticello ruling, collateral descriptions should, at a minimum, include all of the borrower's rights, title, and interests (including all proceeds thereof) in and to "securities accounts," "security entitlements," and "investment property" (each as defined in the UCC of the applicable jurisdiction).[2] For added comfort, lenders may also consider (i) specifying the Cash Sweep program(s) in question and describing the underlying deposits/CDs at participating network banks as "financial assets" in which the borrower has "security entitlements"[3] and/or (ii) listing each Cash Sweep account at the primary bank in detail and identifying such Cash Sweep accounts as "securities accounts." The following is a sample collateral description for the venture lending market, which includes the proper UCC definitions (highlighted in orange), specific references to the Cash Sweep program (highlighted in blue), and a list of the Cash Sweep accounts (highlighted in green):

" "**Collateral**" consists of all of Borrower's right, title, and interest in and to the following personal property: (i) all goods, accounts (including health-care receivables), equipment, inventory, contract rights or rights to payment of money, leases, license agreements, franchise agreements, general intangibles, commercial tort claims, documents, instruments (including any promissory notes), chattel paper (whether tangible or electronic), cash, deposit accounts, certificates of deposit, commodity accounts, fixtures, letter of credit rights (whether or not the letter of credit is evidenced by a writing), securities, securities accounts, security entitlements, and all other investment property, supporting obligations, and financial assets, whether now owned or hereafter acquired, wherever located, including (without limitation) all of Borrower's right, title and interest in and to any and all security entitlements to financial assets consisting of rights to payment under, or otherwise arising from, [ICS PROGRAM NAME/TITLE] maintained by [CUSTODIAL BANK] for the benefit of Borrower in, inter alia, the following securities accounts and other accounts of Borrower at [CUSTODIAL BANK]: [ACCOUNT NUMBER(S)]; and (ii) all Borrower's Books relating to the foregoing, and any and all claims, rights and interests in any of the above and all substitutions for, additions, attachments, accessories, accessions and improvements to and replacements, products, proceeds and insurance proceeds of any or all of the foregoing."

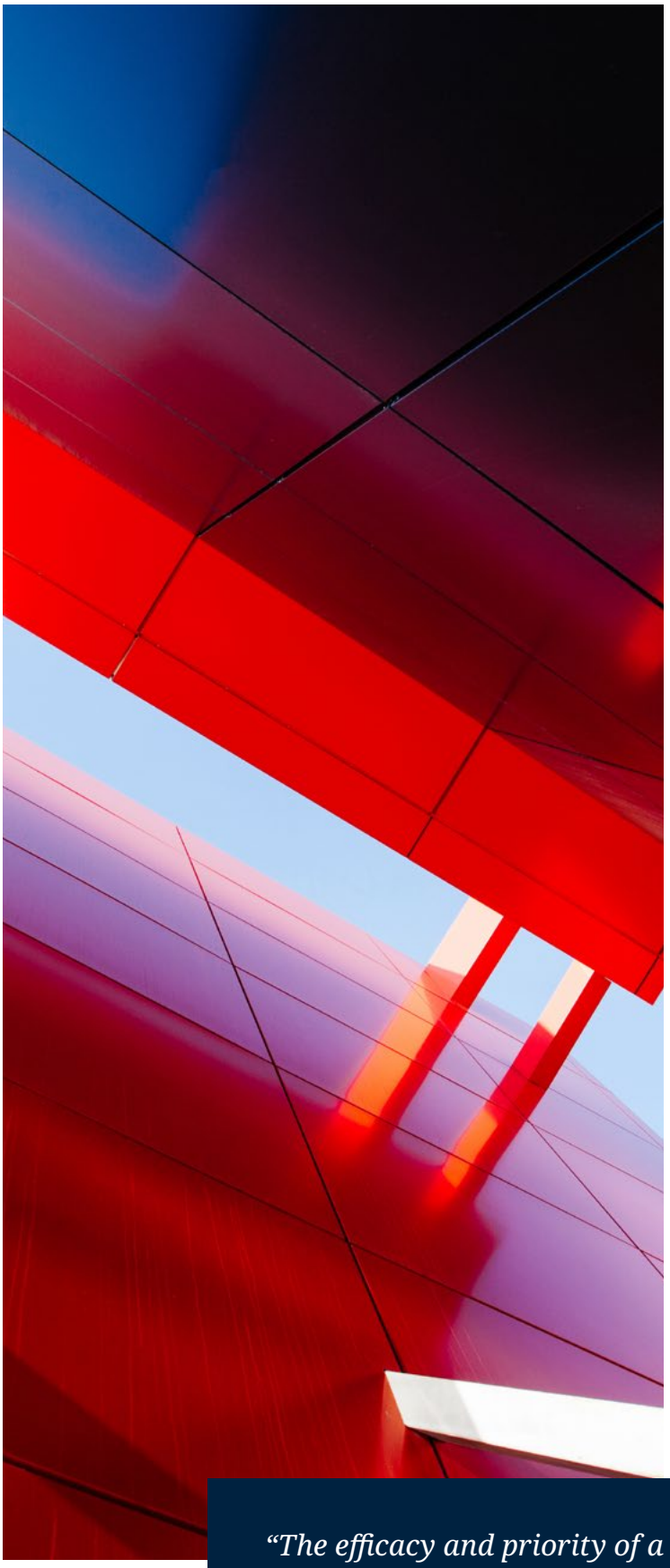
UCC financing statements

In addition to updating the collateral description in the loan documents, lenders are likewise encouraged to attend to the collateral descriptions in any corresponding UCC-1 financing statements filed against the borrower. By way of example, the collateral description for an all assets UCC-1 might reflect the following (with the applicable Cash Sweep portion highlighted in dark blue):

> "All personal property and other assets of the Debtor, whether now owned or hereafter acquired, and wherever located, including (without limitation) all of Debtor's right, title and interest in and to any and all security entitlements to financial assets consisting of rights to payment under, or otherwise arising from, [ICS PROGRAM NAME/TITLE] maintained by [CUSTODIAL BANK] for the benefit of Debtor, all securities accounts pertaining thereto, and all proceeds thereof."

Perfection: Control

Once the collateral description and corresponding attachment have been sufficiently provided for, the next step is ensuring that the security interests are properly perfected under the UCC, by way of "control" under UCC §§ 8-106.[4] As an initial matter, lenders should consider reviewing the Borrower's Deposit Placement Agreement(s) and Custodial Agreement(s) to confirm whether those contain an express agreement between the borrower and the primary bank that the underlying deposits/CDs at participating network banks are to be treated as "financial assets" pursuant to Article 8 of the UCC.[5] The lack of such language will likely need to be remedied, and the method for doing so, as well as the determination of which steps a given lender must take in order to obtain "control," largely depends on whether or not that lender is also the primary bank.



Non-primary bank lenders

If the lender seeking to perfect a security interest is not also the primary bank providing the Cash Sweep product, then a control agreement (aka Securities Account Control Agreement or SACA) between the lender, primary bank, and borrower must be executed in order for the lender to establish "control" (and thus perfection). To be effective for the purposes of effecting "control" under UCC §§ 8-106(d)(2), the SACA must, at a minimum, require the primary bank to comply with "entitlement orders" (as defined in Article 8 of the UCC) originated by the lender without further consent by the borrower. For additional comfort, non-primary bank lenders can also seek coverage under UCC §§ 8-106(d)(1) by (i) requiring that the borrower induce the primary bank to replace the borrower with the lender as the "entitlement holder" on its books or (ii) adding language to the SACA (or other agreement)[6] that would effect such a replacement, automatically, upon a default under the loan or some other triggering event. Lastly, to the extent none of the borrower's Deposit Placement Agreements or Custodial Agreements affirmatively state that the underlying deposits/CDs are to be treated as "financial assets" pursuant to Article 8 of the UCC, a provision providing for such should be added to the SACA (or other agreement).[6]

The following is some sample language for a covenant that can be included in loan documents, which requires the borrower to have its primary bank enter into an agreement (*ie*, a SACA) that would provide the lender with "control" under UCC §§ 8-106(d)(1) (highlighted in grey) and UCC §§ 8-106(d)(2) (highlighted in red):

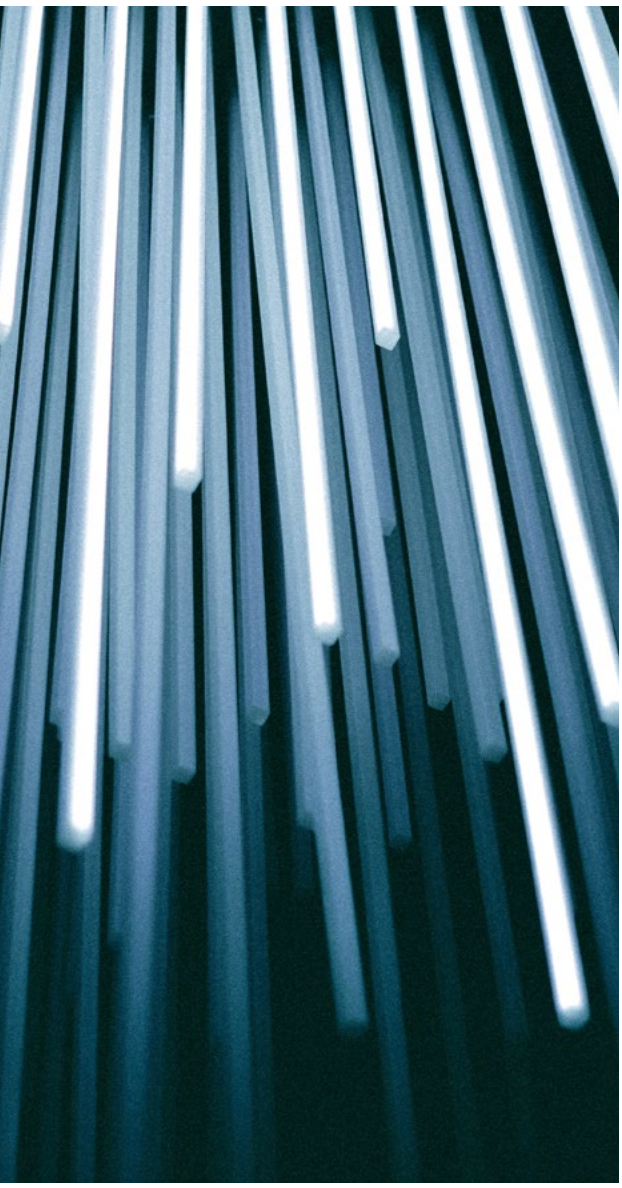
> "With respect to any securities account, Borrower shall cause any applicable securities intermediary maintaining such securities account to show on its books that Lender is the entitlement holder with respect to such securities account, and, if requested by Lender, cause such securities intermediary to enter into an agreement in form and substance satisfactory to Lender with respect to such securities account pursuant to which such securities intermediary shall agree to comply with Lender's "entitlement orders" without further consent by Borrower, as requested by Lender."

"The efficacy and priority of a lender's lien over the Cash Sweeps depends, in part, on the details of the interlocking agreements between the borrower/depositor, primary bank, sub-custodian (if any), and network banks."

Primary bank lenders

Under UCC §§ 8-106(e), a primary bank that is granted a security interest in the borrower/depositor's interests (*ie*, its "security entitlements") in the aggregate custodial accounts (as "financial assets" in a "securities account") will automatically obtain "control" (and thus, perfection), without any further action required, upon the grant (and thus attachment) of said security interest. This gives the primary bank a "super-priority" perfected security interest in the Cash Sweeps under UCC §§ 9-314 and 9-328.

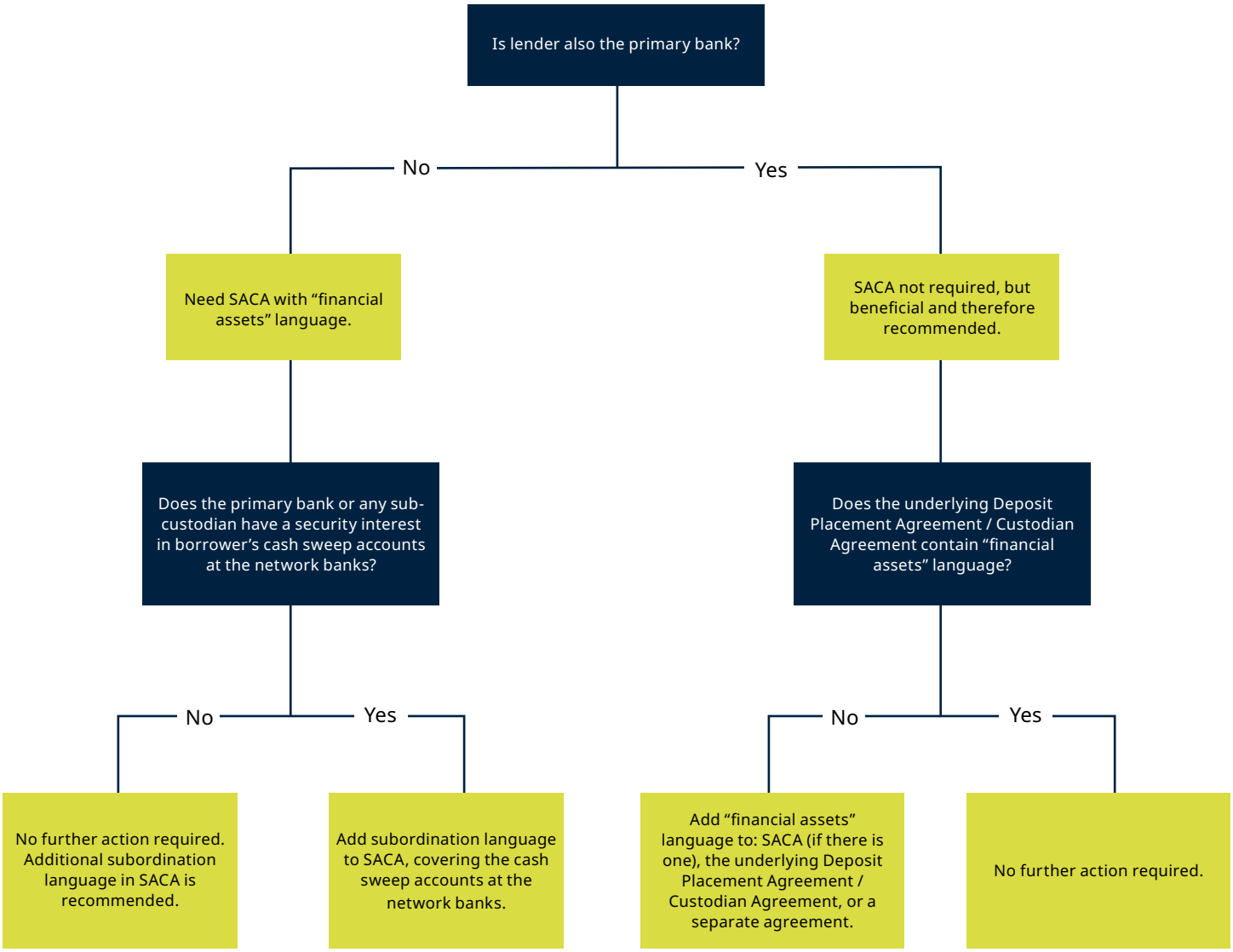
Although a SACA is not required to establish "control" (and thus perfection) for lenders that are also the primary bank where the Cash Sweep accounts are located, having a SACA is nonetheless advisable and would provide additional benefits beyond just perfection of the security interest(s). For instance, if the borrower's Deposit Placement Agreements and Custodial Agreements fail to designate the underlying deposits/CDs as "financial assets" under Article 8 of the UCC, then the SACA can be used to account for that.



Priority and Subordination

SACAs, while generally applicable for most secured lending transactions involving securities accounts (including those without Cash Sweeps as collateral), require some additional considerations when Cash Sweeps are involved, particularly in situations where the lender is not also the primary bank. The efficacy and priority of a lender's lien over the Cash Sweeps depends, in part, on the details of the interlocking agreements between the borrower/depositor, primary bank, sub-custodian (if any), and network banks. Non-primary bank lenders are encouraged to have their borrowers' Deposit Placement Agreements, Custodial Agreements, SACAs, and/or other agreements,[6] as applicable, include covenants and warranties from the primary bank, sub-custodian (if any), and participating network banks (if possible) that each has (i) waived its own security interests and set-off rights (with the proper subordination coverage, discussed below), (ii) acknowledged that the Cash Sweep accounts are held by the primary bank and sub-custodian (if any) in a custodial capacity, and (iii) agreed to accept the custodial sub-account ledgers for purposes of identifying beneficial interests eligible for separate FDIC insurance.

Given the "super-priority" security interest of a primary bank discussed earlier, it's recommended that non-primary bank lenders review the Deposit Placement Agreements and Custodial Agreements of their borrowers to see if those contain anything to the effect of an acknowledgement or confirmation that the primary bank may have been granted a security interest in the borrower's rights in the aggregate custodial accounts (in addition to the borrower's deposit, securities, brokerage, or other accounts). Since most banks' standard form SACAs generally do not address the treatment of Cash Sweeps specifically, a prudent lender would make sure that the subordination provisions of any SACA it enters into with a primary bank, which typically only cover security interests in the borrower's accounts held at the primary bank, also reflect the subordination of the primary bank's lien on the borrower's interests in the aggregate custodial accounts/CDs, so as to properly subordinate the entirety of the subject Cash Sweep(s) – *ie*, both the accounts at the primary bank and those at the participating network banks.



Endnotes

1. Monticello Banking Company v Mark H. Flener, No. 1:10-CV-121-R, 2010 U.S. Dist. LEXIS 132300 (W.D. Ky. Dec. 14, 2010).
2. Note: per UCC §§ 9-108(e), additional description of the collateral is required in cases of "consumer transactions" (as defined in UCC §§ 9-102) – ie, loans to an individual, primarily for personal, family, or household purposes.
3. This is particularly important for lenders that are also the primary bank (see below in "Perfection – Control").
4. In the context of Cash Sweeps, although "control" is generally discussed in terms of control over security entitlements, the establishment of control over any given securities account necessarily imputes such control to the various security entitlements in such securities account from time to time (see UCC §§ 9-106(c)). Therefore, it is preferable to ensure control over the securities account itself rather than over the constituent security entitlements (which are more subject to change, given that the composition of underlying accounts at participating banks – the "financial assets" giving rise to the "security entitlements" in question – are prone to change over the lifetime of the Cash Sweep program). That said, control over both the securities accounts and the security entitlements is best.
5. One question the Monticello ruling did not address is whether or not the constituent CDs were in fact "financial assets" under UCC §§ 8-102. This is important because an underlying "financial asset" is needed in order for a borrower's interest to qualify as a "security entitlement." If the CDARS account didn't contain any "security entitlements," it could potentially be deemed to be something other than a "securities account" and, as a result, some or all of the Cash Sweep collateral might not be considered "investment property." Were that the case, it is unclear what type of collateral the Cash Sweep assets would then constitute under the UCC, leading to ambiguity as to which steps would be necessary to attach and perfect a security interest thereon.
6. Although this can certainly be accounted for in a separate/standalone agreement, parties should try to have it included in the SACA instead, so as to reduce the total number of documents in the overall loan transaction.

For more information

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