GOLDBERG KOHN CLIENT ALERT

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SUMMARY AND ANALYSIS OF THE ABA TASK FORCE MODEL DEPOSIT ACCOUNT CONTROL AGREEMENT

A task force of the American Bar Association has recently completed work on a form deposit account control agreement, with the goal of standardizing practice and facilitating ease of negotiation. Usage of the new model agreement, which may be downloaded free of charge from the American Bar Association's Business Law Section website[1], is not required, however the support of the task force suggests that it may emerge as the basis of future negotiation of deposit account control agreements. This Client Alert summarizes the key features and design of the new model form (referred to in this Alert as "DACA"), so that our lending clients may make informed decisions regarding acceptance of this new model approach.

The model form is comprised of two basic parts. The first part is the form Deposit Account Control Agreement, a tri-party agreement among the secured creditor, depositary bank and debtor. The form agreement is approximately five pages in length, and contains about ten blanks requiring completion by the negotiating parties. These items for completion are referred to in DACA as the "Specific Terms".

The second part of DACA is the "General Terms for Deposit Account Control Agreement", a document of 11 pages setting forth definitions, rules of interpretation and other substantive provisions. This document, which is physically distinct from the Specific Terms, does not contain any blanks for completion, and is not separately signed by the contracting parties. The report issued by the DACA task force in connection with the publication of DACA (the "Report") repeatedly and strenuously discourages contracting parties from making any modification to the General Terms. In our experience, and as noted below, some of the most important and frequently negotiated terms in control agreements in the marketplace today are contained in the General Terms.

Because the General Terms are physically separate from the Specific Terms, and because the General Terms are designed not to be negotiated, it may be the case that some or even many secured lenders presented with DACA as a form for negotiation never actually receive the General Terms. However, the form Deposit Account Control Agreement expressly incorporates the General Terms, so the contracting parties approve the General Terms by signing the Specific Terms. We urge our clients – particularly those individuals among our clients who will determine the usage of DACA as a matter of their institutional practice – to review the General Terms.

Under DACA, a secured creditor seeking to exercise control rights must first deliver to the bank an "Initial Instruction", a form of which is set forth as an exhibit to the model control agreement. A fully signed copy of the DACA must be attached to the Initial Instruction. We therefore recommend that our client's keep ready access to the signed DACA, and verify the existence of a fully signed copy as part of any loan workout.

The function of the Initial Instruction is to direct the bank to cease complying with the debtor's instructions regarding deposit account operations. Both the Task Force report and DACA clearly indicate that the bank has no obligation to comply with an issued Initial Instruction until the document has been actually received by the person, persons or department of the bank designated in the "attention line" of the bank's address set forth in the form Initial Instruction. Accordingly, we strongly recommend that our lending clients complete this notice information with great care. In most cases, we recommend choosing a bank's department as addressee over any specific individual or individuals, as any given individual may be absent from the bank at the time actual delivery is attempted (and DACA provides for no remedy to the secured lender should this be the case). We also recommend that our clients periodically investigate the continued validity of the address information they have specified in any form Initial Instructions, particularly as part of any standard loan workout. The depositary banks have no obligation under DACA to notify their contracting parties should changes in bank personnel or departmental structure render the address information stale.

Concurrent with and at any time following successful delivery of an Initial Instruction, the secured creditor may issue transfer instructions to the depositary bank regarding funds on deposit. However, the bank is not necessarily required under DACA to immediately honor such instructions. First, DACA forestalls the bank's obligations for two business days following receipt of the Initial Instruction, even if disposition instructions are given concurrently with the Initial Instruction. The Specific Terms provide for a negotiated reduction of this gap period but, absent express agreement between secured lender and depositary bank, the default period is two business days. Second, DACA further forestalls the bank's obligations until the bank has received "evidence reasonably required" by the bank "as to the authority of the person" giving the transfer instructions on behalf of the secured creditor. DACA suggests that this "evidence of authority" may take the form of signature cards, directors' resolutions or other comparable proof of authority.

Our lending clients are not generally required to present such corporate authority documents as a condition to the exercise of their foreclosure rights. Accordingly, to the extent any of our clients accept the use of DACA as the basis of negotiating control agreements, we recommend that they consider delivering corporate authority materials to the applicable depositary banks as a standard part of any workout of the credit or earlier Incorporating the delivery of such *(Continued . . .)*

[1]See http://www.abanet.org/dch/committee.cfm?com=CL710060

materials at the beginning stages of a workout or earlier may help avoid delays associated with such deliveries at a more critical stage of the workout. Moreover, delivery of such materials as a routine part of workout strategy, as compared to delivery at a "meltdown" stage of a workout, may prevent the bank and the borrower (should it learn of such delivery) from viewing such deliveries as an early indicator of imminent foreclosure plans.

DACA also sets forth rules, contained in the General Terms, regarding reimbursement and indemnification obligations, topics that have traditionally received significant negotiation. As a general matter, DACA preserves in favor of the depositary bank priority setoff rights against the deposit account, to the extent exercised to recover uncollected, but provisionally credited, funds, merchant card chargebacks, normal service or other fees in connection with the deposit account or any "related services", account adjustments or corrections and reimbursements for out-of-pocket fees and expenses, including the allocable fees and expenses of counsel (including internal counsel) to the depositary bank in connection with the negotiation, administration or enforcement of the agreement by the bank. Other bank setoff rights are subordinated and suspended while the DACA is in place. In addition, the secured creditor agrees to indemnify the depositary bank for all such items, with this specific indemnity limited to the amounts transferred from the deposit account as a result of the bank's transfer instructions. DACA also provides that the contracting parties may limit the survival period for this particular indemnification, with the default rule (absent specific agreement among the parties) being 90 days following termination of the DACA.

Additionally, the General Terms provide for the secured creditor to indemnify the depositary bank for claims "incurred, sustained or payable" by the bank arising from the bank following instructions initiated by the secured creditor, "except to the extent directly caused by the Bank's gross negligence or willful misconduct". While some of our lending clients have often successfully narrowed, and at times even eliminated, this general indemnity as part of negotiations, DACA presents this indemnity as a "non-negotiable" element of the General Terms.

The General Terms also strongly narrow the standard of liability for depositary banks under the agreement. Depositary banks are not liable to secured creditors for claims arising under the agreement "except to the extent directly caused by the Bank's gross negligence or willful misconduct". Secured creditors in many transactions have succeeded in expanding this standard of bank liability to include any bank breach of the deposit account control agreement, without regard to whether the breach constituted "gross negligence or willful misconduct". The Task Force's report acknowledged, but rejected, this market provision. This standard of liability is another "non-negotiable" element of the General Terms.

Finally, DACA raises the question, which is not definitively answered in existing case law, whether certain elements of DACA – such as actual delivery of the Initial Instruction and the tendering of satisfactory evidence of authority – result in a failure to obtain legal control at the time of contract formation for purposes of perfection of a lien on the deposit account under the Uniform Commercial Code. DACA compounds this legal risk to lenders by eliminating all representations and warranties that might otherwise be made by depositary banks concerning the establishment of legal control, thereby shifting this risk entirely to the lenders. To help mitigate this risk, we strongly recommend that our clients utilizing DACA request an unqualified legal opinion of borrower's counsel concerning the establishment of legal control as of the closing date. It may be the case that some counsel will decline to give an unqualified legal opinion on this topic, and instead may be willing to offer only a qualified or "reasoned" opinion. Whether this alternative approach should be acceptable to our clients will turn on the specific content of the opinions and any changes in opinion practice generally in response to DACA.

Secured lenders have three general options to consider with respect to DACA. First, they may fully endorse the model approach. This option has the benefit of reducing transaction costs, at the cost of subjecting lenders to the troublesome provisions of DACA described above. Second, lenders may endorse DACA, subject to making changes to one or more of the "non-negotiable" General Terms. This approach may place lenders in a difficult market position, as they could be portrayed as "cherry pickers". Also, it may be particularly difficult to seek selective negotiation of a document that carries the stamp of approval of a working arm of the American Bar Association. Finally, our clients may reject DACA in its entirety. This approach also risks negative market portrayal. We do suspect that some number of banks will show flexibility on the form of control agreement as a means of garnering cash management business. If lenders reject DACA in its entirety, they may need to be prepared to require their borrowers to change their cash management banks, often a difficult position to strike.

As of the date of this Client Alert, we have seen limited requests for usage of the model form, with most banks still using their pre-DACA, internally developed forms. We expect that over the next several months the dynamics will change, with many banks, particularly large money-center banks, gradually adopting DACA as their standard approach. Please feel free to contact any members of the Goldberg Kohn Commercial Finance Group if you would like to discuss this topic in any further detail.

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