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Feature

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Insured Deposit Sweep Programs: Can We Pretend?

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Driven by panic from the recent rash of bank failures, many corporate entities are reevaluating how they can protect amounts they hold in excess of the $250,000 insurance limit set by the Federal Deposit Insurance Corp. (FDIC).[1] Some companies are turning to products that have recently emerged to fill this gap in FDIC insurance. These products utilize overnight sweep accounts that spread a depositor's cash to additional FDIC-insured institutions (often called "insured deposit sweep programs").[2]

In addition to added FDIC insurance protection, the depositor utilizing an insured deposit sweep program often earns interest at a rate that is well in excess of the prevailing rate offered at their current institution. This makes these programs doubly attractive to the depositor.

However, while these programs give comfort and an increased return to the depositors, they present new issues for secured creditors of those depositors whose collateral is being swept to accounts outside the reach of their deposit account control agreements (DACAs). This leaves secured creditors questioning whether they remain perfected in this cash overnight and what will happen if their borrower files for bankruptcy while these funds have been swept outside of the controlled account pursuant to an insured deposit sweep program.

Insured Deposit Sweep Programs

Various types of insured deposit sweep programs exist to improve a borrower's account insurance. The simplest of these programs involves a customer who signs up with their FDIC-insured depositary bank to spread their excess deposits to other FDIC-insured banks with which the initial depository bank has partnered (often community or other smaller FDIC-insured banks) to open an additional account in the depositor's name. This enables a depositor to interact with its preferred bank but gain the added benefit of increased insurance through its excess deposits being swept to the additional bank(s).

These deposits are held either overnight or for a longer duration based on the customer's consent. Cash sweeps in these programs take place through real-time payments,[3] automated clearinghouse transfers or wire transfers, and may give the depositor constant access to the full amount of their deposits.

Other programs operate similarly but include hundreds of FDIC-insured partner banks, such that the depositor's available FDIC insurance is only capped by the contractual agreement between the parties to the insurance deposit sweep program. These programs will often use a broker-dealer or bank as the agent for the original depositor to spread the funds across partner banks similarly to the program above, but often appear to rely on the FDIC's guidance on "pass-through insurance" such that the initial depositor's funds, once swept, are held in omnibus accounts for the benefit of the depositor by its agent (the administrator of the insured deposit sweep program).[4]

Understanding how these sweep programs work is necessary for lenders whose collateral may be exposed when a borrower uses them. As discussed

1 "Deposit Insurance FAQs," Fed. Deposit Ins. Corp. (March 20, 2023), *available at* fdic.gov/resources/deposit-insurance/faq (last visited Jan. 2, 2024).

2 Despite the fears present in the market, it is worth noting that since 2007, less than 7 percent of all bank failures resulted in depositor losses on deposit accounts in excess of the FDIC's insurance limit. This is largely because the FDIC has provided additional avenues of recovery for depositors, even when their deposits exceed the insurance limits.

3 Real-time payments clear and settle individually with immediate finality, unlike automated clearinghouse payments and wire transfers, which settle through third-party systems that settle either over time or overnight.

4 This article does not analyze whether the insured deposit sweep programs comply with the FDIC's guidance on "pass-through" insurance, but in general it appears that they would.

herein, insured deposit sweep programs may imperil the lender's security interest in their collateral should a bankruptcy be filed while funds are out of the controlled account over which the lender has a security interest.

Perfection Issues with Deposit Sweep Program Funds

Accounts subject to insured deposit sweep programs may form portions of the collateral that support a loan made by a lender to a borrower, and in some instances, might make up a meaningful portion of the collateral that supports a loan (especially in an asset-based-lending context). Perfecting a lien on that collateral should be paramount in the lender's mind. The issue for a lender in the context of an insured deposit sweep program is that the collateral might be spread across numerous accounts at numerous banks.

As an initial matter, the accounts that make up the insured deposit sweep programs might be treated as deposit accounts under the UCC, subject to perfection only via one or more account control agreements (presumably between the borrower, the secured creditor and every FDIC-insured institution where the money might land). The right to payment from the insured deposit sweep programs could be viewed as proceeds of the original collateral over which the secured creditor's lien is maintained.

Alternatively, as a potential method of perfecting its lien in cash, it is possible that the cash swept to the administrator of the insured deposit sweep program could be asserted to be investment property that is subject to perfection by the applicable Uniform Commercial Code (UCC) financing statement. In any event, if there is an intervening bankruptcy case filed, the use of an insured deposit sweep program may leave the secured creditor exposed to a potential challenge to the perfection of their security interest on the cash collateral remitted back to the deposit account through the cash sweep program.

Deposit Accounts

Deposit accounts must be perfected through control. While establishing control over the initial deposit account may be accomplished through a DACA or possession, it is less clear as to how a lender can establish control over funds that are swept out of that account to partner banks with whom they do not have a DACA.

As previously discussed, some sweep programs spread funds across numerous accounts at many institutions. It would likely be impractical, if not impossible, to enter into DACAs at each institution in a deposit insurance sweep program. Moreover, the ability to obtain additional DACAs would be further frustrated by the lack of a borrower having its own account at most partner banks in large insured deposit sweep programs if the program utilizes "pass-through" FDIC insurance[5] and no actual account is opened by the borrower.

Lenders will have to ask themselves hard questions as to whether they believe that they can establish control over swept funds, rely on the UCC's default provisions that would permit the lender to maintain that it remained perfected in the cash no matter where it is held for the statutory period, or negotiate the terms of an applicable credit agreements to prohibit the use of the insured deposit sweep programs absent consent from the lender. Otherwise, it is not hard to imagine a scenario in which the funds are swept, a bankruptcy has been filed and the lender is left with, at best, defending against claims that there is no perfected security interest in the swept cash.

Answers may lie in the specific drafting of a credit agreement or DACA, or perhaps in using more aggressive methods of control that might block or limit a borrower's use of some types of, if not all, insured deposit sweep programs. Absent implementation of protections, lenders might be left holding a perfected security interest in a mostly empty account when a bankruptcy is filed.

Investment Property

Investment property may provide a better argument for perfection in some sweep programs. The relevant type of investment property would likely be a securities account. More specifically, "'[s]ecurities 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."[6] Assuming that cash can fit the "financial asset" definition, whether there is an agreement of the type described in the UCC will depend on the particulars of the sweep program being employed.

Maintaining that the money is a financial asset may put lenders in a slightly better — but still precarious — position. A financial asset is generally a security, an obligation or interest that is traded on financial markets and generally recognized as a medium for investment, or "any property that is held by a securities intermediary for another person in a securities account if the securities intermediary has expressly agreed with the other person that the property is to be treated as a financial asset under this Article."[7]

One could argue that under this broad language, an account holding only money could be a financial asset if the parties agree it is a financial asset. However, that position may be precarious, as accounts holding only cash might not be holding the cash as investment property.[8] Cash is not of the same type of collateral as the others mentioned in the definition.[9]

Moreover, cash (in its pure form, as opposed to being shorthand for a debt between a depositor and institution) generally has its own rules of perfection that require possession.[10] An account holding only cash therefore might be

5 FDIC "pass-through" insurance provides for the insurance of deposit accounts at FDIC-insured depository banks where the funds are owned by an entity, but are held in an account of a depositor who holds it in a fiduciary capacity. These accounts are often commingled with other such deposits in an omnibus account. As long as the recordkeeping has been properly maintained, the FDIC insurance provided for these comingled, omnibus accounts is provided based on the ownership of the funds and not based on the account being in the name of the fiduciary.

6 *See, e.g.*, N.Y. U.C.C. Law § 9-501(a).

7 *See, e.g.*, N.Y. U.C.C. Law § 8-102(a)(9)(iii).

8 *See In re GEM Refrigerator Co.*, 512 B.R. 194, 204-05 (Bankr. E.D. Pa. 2014) (holding that deposit accounts and investment property are mutually exclusive, and, in context of account-holding securities and cash, only describing securities as financial assets).

9 *See, e.g.*, N.Y. U.C.C. Law § 8-102(a)(9)(iii).

10 *See, e.g.*, N.Y. U.C.C. Law § 9-312(a)(3) ("[A] security interest in money may be perfected only by the secured party's taking possession under Section 9-313.").

better classified as another type of collateral governed by another part of the UCC. As such, there might be risk in attempting to classify cash as a financial asset.

There might be an advantage to the lender seeking to classify the swept collateral as investment property, because perfection may be easier. Perfection of a securities account may be established through control, as with a deposit account. Unlike a deposit account, though, perfection may also be established through a UCC-1 financing statement, albeit potentially at a lower priority.[11] Because perfection through the use of a UCC-1 allows for a more general description of the property being secured, it may provide a more viable avenue toward perfection of swept funds. However, if this provides a lender with an advantage in the near term, it will only be setting the lender up for a battle in the event of bankruptcy.

Given the precarious nature of the classification as a financial asset discussed herein, lenders would almost certainly be setting themselves up for litigation with the debtor, trustee or creditors' committee. These groups will likely argue that the lender did not have a perfected security interest in the deposit account at filing, making these funds available to the unsecured creditors.

Conclusion

FDIC sweep programs appear to shift and amplify risk for a secured lender while providing protection at limited downside risk to a borrower. However, borrowers will likely pressure lenders to permit the usage of insured deposit sweep programs in order to shed their risk and increase the returns that they get on overnight deposits.

When presented with a request for a borrower to utilize such a program, a lender should at least discuss with the borrower whether they need to hedge a bank failure based on the general lack of damages to depositors in bank failures, and weigh that risk against the potential risk to their collateral should a bankruptcy be filed. However, because the usage of these programs for a healthy company at the outset of a loan relationship likely provides little to no risk for a lender, initial lines of business will likely be willing to permit borrowers to utilize these programs under the loan agreement.

At the time when the borrower begins using one of these insured deposit sweep programs or at the negotiation of the applicable loan documents, lenders should request that the lender will always have a first-priority perfected security interest in any of the deposits of the borrower utilized in an insured deposit sweep program. This should include a request to include the two major types of the sweep programs previously discussed (those that utilize cash sweeps between banks directly, and those that use broker-dealers to hold investment property). In other words, this opinion should include a discussion of the swept cash deposits as a financial asset if the use of such a program will be permitted. However, given the murky nature of the legal analysis as discussed herein, borrower's counsel may be reticent to provide such an opinion.

When a lender sees signs of distress in the borrower or the credit moves toward a workout situation, the lender should consider restricting or directly prohibiting the usage of these insured deposit sweep programs as part of the amendment or forbearance process. If the program has been utilized by the borrower, upon a bankruptcy filing by the borrower it is likely that the committee (or, in some instances, a debtor or trustee) will challenge the perfection of the funds that are in the insured deposit sweep program.

The lender may assert that the funds held are their identifiable cash proceeds, but that may simply invite a fight that will require the lender to trace these proceeds through the various accounts in which they were held. Regardless of the merits of these claims by the estate, the cost of vindicating the lien will often bring parties to the table to settle the issue, depriving the lender of a portion of its collateral. abi

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11 *See, e.g.*, N.Y. U.C.C. Law § 9-328.