

# RE-PERFECTION OF A LAPSED SECURITY INTEREST

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You receive a call from your Canadian bank client (“Bank A”) with the following issue: Due to an internal reshuffle in its portfolio management department, it has neglected to file timely renewals of certain UCC / PPSA (Personal Property Security Act) financing statements on a cross-border credit facility. As a result, these registrations have lapsed and Bank A is currently in an unperfected position. The manager is under the impression that he merely needs to file renewal statements at present and Bank A’s security interest will remain continuously perfected even during the lapse period. Is he right?

## **Re-Perfection under the PPSA**

While we do not practice Canadian law, we have encountered Ontario PPSA 30 (6) which provides as follows:

*(6) Where a security interest that is perfected by registration becomes unperfected and is again perfected by registration, the security interest shall be deemed to have been continuously perfected from the time of first perfection except that if a person acquired rights in all or part of the collateral during the period when the security interest was unperfected, the registration shall not be effective as against the person who acquired the rights during such period. R.S.O. 1990, c. P.10, s. 30 (1-6).*

Therefore, we have been advised by Canadian counsel that a late renewal serves to re-perfect and Bank A’s security interest is deemed continuously perfected since the original filing, even if there is a second-priority lien in favor of Bank B on file. However, if Bank B makes a filing during the lapse period (or more generally, if Bank B otherwise “acquired rights” in the collateral [1] during this period), Bank A would lose its priority to Bank B.

## **Re-perfection under the UCC**

A UCC-1 financing statement will automatically expire five years after the date of its filing [2]. UCC § 9-515(d) provides that a continuation statement may be filed only within the six-month period prior to the expiration of the five-year period specified in the previous sentence; a continuation statement filed other than as prescribed by such subsection is ineffective. It is our practice to advise our clients upon the filing of an initial UCC-1 financing statement that it is crucial to diary the

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filing of a continuation statement during the prescribed period with its loan management team.

UCC § 9-515(c) provides for the consequences of a lapse period:

*Upon lapse, a financing statement ceases to be effective and any security interest or agricultural lien that was perfected by the financing statement becomes unperfected, unless the security interest is perfected otherwise. If the security interest or agricultural lien becomes unperfected upon lapse, it is deemed never to have been perfected as against a purchaser of the collateral for value.*

Under the UCC, there is no equivalent to “deemed continuous perfection” provided by PPSA 30 (6) discussed above. Rather, once a UCC financing statement lapses, it essentially disappears. Bank A can re-perfect once it discovers the lapse and file a new UCC-1 financing statement, but if Bank B had a UCC financing statement on file during the lapse period, such financing statement would trump Bank A’s later filing without any action on the part of Bank B.

### **Divergent Policy Considerations**

As U.S. practitioners who frequently encounter Canadian legal issues in our cross-border practice, we have often speculated on the underlying policy rationale that explain divergent legal outcomes reached under the UCC and PPSA, respectively. A trend that we have observed is that where the regimes reach divergent outcomes, the result reached by the PPSA tends to emphasize equity considerations, whereas the result reached by the UCC stresses procedural certainty. These tendencies appear to be reinforced by the above discussion on re-perfection.

Under the PPSA, if a bank becomes unperfected and there has been no intervening action by another secured party, it seems “fair” that it gets to keep its spot in line by re-perfecting. In contrast, the UCC position places the emphasis on compliance with its established procedure for renewal. If the financing statement is not timely renewed, the lapse is automatic and the UCC is clear as to the consequences for all parties flowing from such lapse.

### **Preference Risk**

The discussion above highlights the necessity for secured parties to monitor their registrations and diligently prepare renewals. The lack of a re-perfection mechanism and the precise specifications for renewal filings in the UCC make this renewal procedure particularly crucial in connection with U.S. security interests. A further complication is introduced by the U.S. law on preferences.

Under U.S. bankruptcy law, preferences are certain transfers of a debtor’s property made voluntarily or involuntarily by an insolvent debtor within 90 days of bankruptcy (or one year, if to an insider). These transfers are made on account of a pre-existing debt with the effect of favoring certain creditors over others. The good faith of the parties to the transfer is irrelevant. If found to be a preference, the transaction can be voided and recaptured by the debtor and returned to the bankruptcy estate to be equitably distributed to the general pool of creditors.

Because there is no re-perfection under the UCC, a subsequent filing made after a lapse is treated as a grant of new security to secure an antecedent, unsecured debt. If the debtor is insolvent at the time of this filing and it ultimately goes into bankruptcy in 90 days – all the elements of a preference under the U.S. Bankruptcy Code are satisfied [3] and this grant of security is voidable for giving the creditor more than it would be entitled to under a liquidation. This is certainly a serious and unintended consequence of a late renewal! We would welcome any feedback from Canadian readers to confirm if an

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analogous situation arises under Canadian law.

Please note the PPSA discussion in this blog post relates only to our understanding of the Ontario PPSA. If any readers are familiar with how re-perfection is handled in other jurisdictions, we would love to hear from you!

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[1] We have been advised by Canadian counsel that the making of advances by Bank B during the lapse period may be enough to “acquire rights in the collateral” and if it does so, Bank B may take priority over Bank A even if Bank A subsequently files a renewal to be continuously perfected.

[2] UCC-1 financing statements filed in respect of certain special scenarios are subject to different durations rules. For example, UCC-1 financing statements filed in respect of public-financed transactions have a 30-year effective period. (UCC § 9-515(b)) and UCC-1 financing statements filed in respect of transmitting utilities have an unlimited effective period. (UCC § 9-515(f)).

[3] See § 547(b) of the U.S. Bankruptcy Code.