The Care and Feeding of Continuation Statements - When Are They Needed and When Are They Effective?

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Casenote: The Care and Feeding of Continuation Statements—When Are They Needed and When Are They Effective?

By William E. Carroll and Alvin C. Harrell

I. Introduction

Several years ago one of your authors noted the basic risks inherent in any effort to "continue" the life of a financing statement beyond its initial five year span. At that time, it was noted that the U.C.C. rules governing continuation statements not only pose risks for senior secured parties but also provide potential opportunities for junior secured parties to improve their positions as a result of errors by senior parties. Now, in a senior creditor's nightmare come true, In re Adam has vividly illustrated the practical ramifications of a failure to closely monitor the timing of a creditor's filing of continuation statements.

II. Background -- The Ineffective Continuation Statement

Creditors and their counsel always should be alert to the possibility that a continuation statement that has been filed by the holder of a "senior" security interest may not have been timely filed. Subsection 9-403(3) of the U.C.C. provides in part:

A continuation statement may be filed by the secured party within six (6) months prior to the expiration of the five-year period specified in subsection (2) of this section... Upon timely filing of the continuation statement, the effectiveness of the original statement is continued for five (5) years after the last date to which the filing was effective whereupon it lapses in the same manner as provided in subsection (2) of this section unless another continuation statement is filed prior to such lapse.

At least three attorneys general have rendered opinions to the effect that a continuation statement filed more than six months prior to the expiration of the five year period (for which the prior financing or continuation statement is effective) is a nullity. In those situations where a holder of a "senior" security interest has failed a continuation statement prematurely and five years have elapsed since the prior financing or continuation statement was filed, a creditor that previously had been holding a junior security interest or lien may successfully contend that it now holds the senior secured position.

Furthermore, it should be noted that pursuant to the provisions of subsection 9-403(3), as quoted supra, when a continuation statement has been timely filed, the new five year period of effectiveness for the financing statement commences upon expiration of the prior five year period, and does not date from the time that the continuation statement was filed. As a result, a creditor who is counting successive five year periods from the date that each continuation statement was filed may eventually fall into the trap of filing a continuation statement more than six months prior to the expiration of the five year period during which the current financing or continuation statement is actually effective. This problem is, of course, more likely to arise in revolving credit arrangements or other long term credit arrangements that extend over successive five year periods. The practical effect of this danger is illustrated by In re Adam.

III. The Ineffective Continuation Statement -- In re Adam

In Adam three continuation statements were filed, for the purpose of continuing the perfection of a Farm Home Administration (FmHA) security interest in agricultural collateral. The original financing statement (form UCC-1) was filed January 27, 1971. Continuation statements were filed September 8, 1975, September 11, 1980, and April 18, 1985. The debtor filed for relief under Chapter 7 of the Bankruptcy Code on June 19, 1986, and the trustee in bankruptcy subsequently challenged the effectiveness of the April 18, 1985 financing statement.

The trustee pointed out that the timing of the April 18, 1985 continuation statement failed to conform to the requirements of U.C.C. subsection 9-403(3), so that the perfection of the security interest had lapsed.

1. See Carroll, "The Ineffective Continuation Statement," Bank-
   ing Law 1986 (Oklahoma City University, Continuing Legal
   Education, April 11, 1986), at 10 (hereinafter Carroll). A filed
   financing statement ceases to have effect, for purposes of perfec-
   tion, five years after its initial filing unless contended by timely
   filing of a continuation statement. See Uniform Commercial
   Code (U.C.C.) § 9-403 (1987 Uniform Text), infra text at
   note 5.

2. See Carroll, supra note 1, at 17.

   supra Part III.

4. This portion of this article is derived from Carroll, supra note 1.

5. U.C.C. § 9-403(3) (emphasis added).

   702 (1984); Opinions of the Attorney General of North Carolina,
   22 U.C.C. Rep. 266 (1977), and Opinions of the Attorney General

7. 7 U.C.C. Rep. Serv. 2d 1291.

8. These facts are recited in 7 U.C.C. Rep. Serv. 2d at 1292-1293.
and the previously secured party had become an unsecured creditor. The court agreed and the secured party became unperfected.

Specifically the trustee noted that the first continuation statement must be filed within six months prior to the expiration date (five years from the date of the financing statement), and if that statement is not timely filed, the lien expires. The continuation statement must be filed within six months prior to the expiration date of the financing statement. The continuation statements are cumulative and expire after five years unless filed. If the second continuation statement is filed within six months of the expiration of the financing statement, the lien is extended for another five years. If no such continuation statement is filed, the security interest expires at the end of the five-year period.

In the case at bar, the First Financing Statement, filed on April 27, 1976, expired on April 27, 1981. The second continuation statement was filed on September 27, 1978, and the Third Financing Statement was filed on September 27, 1980. Therefore, the lien expired on September 27, 1981, and the security interest, by the terms of Section 9-403 of the UCC, was perfected.

If a security interest expires, the secured party may, within 10 days after the expiration, file a continuation statement under Section 9-403 to extend the duration of the security interest for another five years. The lien is perfected and no further filing is required.

Therefore, the security interest is perfected and the lien is not subject to the defense of perfection. The lien is perfected and the security interest is not subject to the defense of non-perfectness.
VI. Summary and Conclusion

It is clear that, under U.C.C. subsection 9-403(3), continuation statements must be filed within six months before expiration of the five year effective period of the prior statement, regardless of when a continuation statement was filed. If a continuation statement is not filed in timely manner, the perfection lapses and the secured creditor’s only recourse is to refile a new financing statement. In that event perfection will date from the time of the new filing.

There is an exception to this lapse rule at subsection 9-403(2), for insolvency proceedings. Unfortunately this exception has been misconstrued in cases like Banque Paribus and Nardulli, with the result that considerable uncertainty now exists regarding the application of this important subsection and the duties it imposes on secured parties.

Commentary: Reflections on FIRREA

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Without a viable, independent thrift industry, who will serve these needs? Regrettably, the modern answer is likely to be more regulation from Washington in an effort to force other financial institutions to serve these markets. Already there have been proposals to mandate “lifeline banking” and “truth in savings,” and FIRREA requires the regional Federal Home Loan Banks to institute affordable housing programs, as well as containing the seeds of other credit allocation measures. Ultimately the result is likely to be increased movement toward use of the financial system as a tool for social engineering. It will be interesting to see whether the public is as well served by this approach as it was by a deregulated thrift industry.

As a final observation one should note that these kinds of things often turn out differently than one expects; human affairs continue to be governed partly by the law of unintended consequences. In this instance the very stringency of the regulations and restrictions imposed on the thrift industry, which seem designed to promote an exodus from that industry, may so adversely affect the marketability of the thrift charter as to impair the ability of owners (including the government) to sell or merge their institutions.

Clearly the inability of thrifts under FIRREA to diversify away from reliance on residential mortgage lending increases the risks associated with declining real estate values and regional economic downturns (which factors contributed so greatly to the FSLIC insolvency); in this sense FIRREA is blatantly counter-productive and seems likely to set the stage for further thrift crises. Together with the risks to thrift owners posed by the new civil money and criminal penalties and other regulatory enforcement powers, and other FIRREA-related restrictions and complexities, FIRREA creates considerable disincentives for investment in a thrift institution. This, in turn, may make it more difficult for current owners to get out of the business, thereby inadvertently tending to preserve the status quo of a separate thrift industry.

Separate, of course, does not mean equal, and the prospective health of the thrift industry is quite another matter. Still, and despite all of the publicity to the contrary, most of the thrifts in this country are solvent and are at least marginally profitable. While in many instances (and probably as an overall matter as well) FIRREA will impair that health, the chances are that many thrifts will survive FIRREA and will adapt somehow to the conflicting pressures of the new regulatory and competitive environment. Perhaps unable to sell or merge, many healthy thrifts probably will “tough it out,” with the result that a significant part of the thrift industry may survive (a sizable achievement considering the forces that have battered this industry over the past two decades).

The new thrift industry will, of course, be sharply diminished, both in relation to its former self and its previous potential. In this respect it may be the nation, and not just the thrift industry, that suffers the ultimate loss.

[The views expressed in this commentary are solely those of the author and do not represent the Conference on Consumer Finance Law or the members of its Governing Committee.]