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In Depth: A Perfection Problem with a Hidden Solution

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Most U.S. lenders are familiar with the need to file a Uniform Commercial Code financing statement to perfect a security interest in collateral. Most lenders are also aware that financing statements must be updated if the debtor changes its name, changes its jurisdiction of organization, etc. However, when a debtor converts from one entity type to another (*e.g.*, a corporation converts to a limited liability company), a technical difficulty arises that many lenders would find difficult to navigate.[1] Unfortunately, the consequences may include loss of perfection or priority of the lender's security interest. This note describes the issue and explains the best way to address it.

It is important to note that the issue described below was identified years ago by John Hilson and Steve Weise[2], and the solution was implemented by updating the official comments in connection with the 2010 amendments to the UCC.[3] However, because the solution was implemented entirely within the official comments to the UCC, and not in the text of the UCC itself, the solution (and indeed the problem) may not have come to the attention of some lenders and their advisers. This is especially true because at this time the official comment explaining how to avoid the issue has not made its way into the LexisNexis Goldbook used by many New York commercial lawyers or into the District of Columbia's codification of the UCC (which generally includes the official comments). As a result, even a lawyer who diligently reviews both the text of the UCC and the official comments may be left in the dark. The purpose of this note is to bring the issue to light.

The problem arises when a debtor converts from one entity type to another[4] and in the process changes its name in such a way that a search against the new name wouldn't return the original UCC1 financing statement.[5] In this case, the secured creditor must take action to maintain the perfection of its security interest. But what is it required to do?

If the borrower is the same legal person before and after the conversion, the UCC regards the conversion as a mere name change. In that case, the typical approach would be to file a UCC3 amendment statement updating the name of the debtor, as contemplated by Section 9-507(c).

By contrast, if the conversion is effected by extinguishing the original entity and creating a new entity, then under the UCC there has been a disposition of the collateral and a new debtor has become bound by the security agreement. In that case, the typical approach would be to file a UCC1 financing statement naming the new debtor, as contemplated by Section 9-508.

The problem is that the correct choice depends on which type of conversion has occurred – one that preserves the same entity, or one that creates a new entity. The UCC does not govern this question but instead leaves it to other law to resolve. In some cases, the non-UCC law governing the conversion process is ambiguous as to whether a new entity is formed.

This ambiguity is unfortunate because if the lender picks the wrong approach, it may suffer severe consequences. If the lender files a new UCC1 financing statement when it should have filed a UCC3 amendment statement updating the debtor's name, then its original UCC1 will cease to be effective to perfect a security interest in collateral acquired more than four months after the name change. The new UCC1 should maintain perfection, but its filing date would not relate back to the original UCC1, with potential consequences for the priority of the lender's security interest (and with even more severe consequences if the borrower files a bankruptcy petition less than 90 days after the new UCC1 is filed).

Even worse, if the lender files a UCC3 amendment statement changing the debtor's name when it should have filed a new UCC1 financing statement, then the lender will not have the benefit of an effective financing statement against the debtor. Unless it perfects its security interest by some other method, the lender will be unsecured.

As a result, the question of whether a new debtor has been formed in an entity conversion was traditionally a crucial one for a secured lender, and there was no safe alternative in the face of ambiguity. Lenders had to take their best guess, and if they guessed wrong, they suffered the consequences.

To solve this problem, the official comments were updated in connection with the 2010 amendments to the UCC. In particular, Official Comment 5 to Section 9-512 now states that when faced with this situation, a secured party can simply file a UCC3 amendment statement adding a new name for the debtor. This would meet the UCC's requirements for both a change in the debtor's name and for a disposition of collateral to a new debtor, so it covers all the bases.

Of course, a lender can choose to take one of the traditional approaches described above, and if it chooses the right one, it will be fully protected. But given that the same result can be obtained with complete certainty by filing a UCC3 amendment adding the borrower's new name, this should be considered the state-of-the-art approach when a borrower converts to a new entity type.[6]

This resolution, while effective and elegant, tended to fly beneath the radar due to the confluence of factors described above. But now, when your debtor converts to

a new entity type, you will know what to do.

[1] The same issue can arise when an entity merges into another entity, but for simplicity the focus here is on a conversion from one entity type to another.

[2] Hilson's and Weise's commentary can be found at:

https://www.uniformlaws.org/HigherLogic/System/DownloadDocumentFile.ashx?DocumentFileKey=efa6b9bc-4067-9757-9506-795f13cccf00

[3] See Official Comment 5 to Section 9-512 of the UCC, discussed more fully below.

[4] This entire note assumes that the conversion takes place within a single jurisdiction – for instance, a corporation organized in a given jurisdiction converts to an LLC organized in the same jurisdiction. A cross-border entity conversion would raise additional issues.

[5] If a search against the new name would return the original UCC1 financing statement, then the conversion has not caused the financing statement to become "seriously misleading" under Section 9-506(c) and it remains effective to perfect the security interest.

[6] As noted in Official Comment 5 to Section 9-512, the lender may consider filing both the UCC3 described above and a new UCC1 against the new debtor name.