

# community BANKER

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Welcome to the May/June issue of the COMMUNITY BANKERS' ADVISOR.

The ADVISOR is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

## YOU ARE ASKING . . . .

**Q: What is the required delinquency time requirement for foreclosing residential mortgages?**

**A:** Briefly, Title X, RESPA regulations of 2014 provide that loan servicers must not make the first notice or filing required for the foreclosure process until a residential mortgage loan is more than 120 days delinquent. The "first notice" in North Dakota is the Notice Before Foreclosure, so there must be a delinquency of at least 120 days before that document can be sent to the borrower if the loan is secured by a residential mortgage on the primary dwelling.

## LIEN ON ME

Ah, perfection! You've filed your financing statement, but you really shouldn't ignore it for the next five years or until the loan has been paid off; perfection must be preserved or it may cease to be effective. Gaps in perfection can let other creditors gain priority over you by perfecting their liens in the same collateral at a time when *your* perfection has lapsed; lapses or gaps in perfection can also lead to a "re-perfection" being set aside in bankruptcy under preference rules.



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Most loan agreements include (or should include) a clause requiring the borrower to preserve the perfection of the secured party's security interest. If the borrower doesn't comply, that failure will be an "event of default" giving the secured lender the right to accelerate the loan and foreclose on the collateral. Remind the borrower at the outset that it must ensure continued perfection of the security interest to avoid default; the event of default may even spark a cross-default under other loan agreements to which your borrower is a party. Unfortunately, other than a suspended reminder to renew a financing statement six months before lapse, lenders typically don't have the ability to monitor the ongoing perfection of their security interests.

That said, lenders don't have to sit idly by and hope for the best. Consider including "affirmative covenants" in the loan documents that require the borrower to notify the lender of any changes that might affect perfection, such as a change in the borrower/debtor name or the state of organization of the borrower. Consider putting some of these notification requirements in a biannual or annual acknowledgment to be provided by the borrower, *i.e.* "I, John Smith, President of XYZ, Inc., certify that XYZ, Inc. has not changed its name . . . etc."

All North Dakota lenders should have a user account by now for online filing, including continuations and amendments of previous paper-filed financing statements. The North Dakota Secretary of State's office has implemented its new Central Indexing System (CIS), and state law now requires that all central indexing filings and search requests be completed online. Paper filings and search requests are no longer accepted by the state or county filing offices. Additionally, all filings in the North Dakota CIS require the debtor's social security number or federal employer identification number.

The watchful lender must be aware that there are a number of different issues that might affect perfection of a financing statement, including lapse, name changes, change in jurisdiction or location, changes in address, and changes in entity.

**a. Lapse**

Under N.D.C.C. § 41-09-86, a UCC-1 financing statement is effective for five years after the date of filing. To prevent a financing statement from lapsing in North Dakota, the secured lender must make a "UCC-3(Amendment)" filing. (Somewhat perplexing, continuations, terminations, assignments, and amendments are now all classified as "amendments" and require the continuing party to click on the "UCC-3 (Amendment)" filing choice in order to process one of these four filing types. See page 14 of the new CIS User Manual.) A continuation may *only* be filed within six months prior to the lien's lapse date, and should clearly describe the specific financing statement to be continued. If the UCC-3 continuation is filed within the stated time period, the original financing statement will remain effective for an *additional* five years; a continuation can be made in repeated additional five-year terms. If the continuation is not filed within the six months prior to lapse, the original filing will lapse and the security interest is no longer perfected. If that happens, immediately file a new UCC-1, but be aware that the perfection will date from the filing of the new financing statement and that you will not have the priority from the earlier filing date. That means that the creditor that filed two years after you now has priority because your initial, first-in-time filing lapsed. Also, if a third-party filing is made *after* the lapse and *prior* to the date of your new financing statement, that filing will likely have priority over you. Too, your new filing could also be set aside in bankruptcy as a preference if the filing is made or deemed to have been made at a time when your borrower is insolvent.

**b. Change to borrower's name**

Under N.D.C.C. § 41-09-78(3), if a change to the name of a borrower causes the filed name to be seriously misleading to third parties, the original financing statement will be effective only with respect to collateral

acquired before the name change or within four months after the name change. Because UCC filings are automatically indexed by the name of the borrower, the safest course is to file a UCC-3 amendment whenever the borrower has changed its name in order to avoid challenges to priority and arguments about whether the name change was seriously misleading.

If a lender fails to make the UCC-3 amendment to reflect the name change, it will not be secured in collateral acquired four months after the name change. All is not lost, however, and the original financing statement will remain effective to preserve the security interest in the *original* collateral. For example, your security interest in “long-term” collateral such as equipment and machinery will remain, but the security interest in “turn over” collateral such as inventory or supplies will lapse as the original collateral is replaced. The prudent lender should require that the borrower disclose all names it has used in the past five years. If your borrower has used any other names during the past five years, do a UCC search on all earlier names as well as its current name in order to check for competing liens filed against those other names.

If a lender fails to file the UCC-3 amendment within four months of the seriously misleading name change, it should perfect a security interest in new collateral by filing a new, original financing statement. While it’s better, obviously, to file a timely UCC-3 amendment and avoid the risk of intervening creditors and preference issues, filing a new UCC-1 is the only option if four months have passed since the name change.

**c. Change in borrower’s address**

If the borrower moves to Minot from Bowman or from the north side of Williston to the south side, he or she or it is still in the State of North Dakota. If a change of address doesn’t bring about a change of jurisdiction, perfection generally will not be affected. Under N.D.C.C. § 41-09-21, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral.

**d. Change in borrower’s jurisdiction**

If borrower John Doe moves to Wyoming from North Dakota, there is a change in the borrower’s jurisdiction. If XYZ, Inc. reorganizes itself in a Texas by filing its organization papers with the Texas Secretary of State but still remains the legal entity XYZ, Inc. operating out of Bismarck, there is a change in the borrower’s jurisdiction. Generally, under N.D.C.C. § 41-09-36(1)(b), there is a four-month window in which any existing security interest remains perfected after the move. If a secured party properly re-perfects its security interest before it becomes unperfected due to the change in a borrower’s jurisdiction, then the security interest remains perfected continuously thereafter.

Example 1: Debtor is a general partnership whose chief executive office is in North Dakota. Lender perfects a security interest in Debtor’s equipment by filing in North Dakota on May 15, 2012. On April 1, 2015, without Lender’s knowledge, Debtor moves its chief executive office to New Jersey. Lender’s security interest remains perfected for four months after the move.

Example 2: Debtor is a general partnership whose chief executive office is in North Dakota. Lender perfects a security interest in Debtor’s equipment by filing in North Dakota on May 15, 2012. On April 1, 2017, without Lender’s knowledge, Debtor moves its chief executive office to Minnesota. Lender’s security interest remains perfected only through May 14, 2017, when the effectiveness of the filed financing statement lapses (the five years are up!). Although, under these facts, Lender would have only a short period of time to discover that Debtor had relocated and to reperfect under Minnesota law, Lender *could have* protected itself by filing a continuation statement in North Dakota six months prior to the lapse date

and before Debtor relocated. By doing so, Lender would have prevented lapse *and* allowed itself the full four months to discover Debtor's new location and refile there.

Example 3: Under the facts of Example 2, Lender files a financing statement in Minnesota before the effectiveness of the North Dakota financing statement lapses. Under N.D.C.C. § 41-09-36(2), Lender's security interest is continuously perfected beyond May 14, 2017, for a period determined by Minnesota's law.

**e. Change in secured party/lender address**

A change in the address of the secured party does not affect the perfection of the security interest. However, a lender that changes its address may consider filing a UCC-3 amendment to inform the world of its new address. This makes it easier for third parties to contact the secured party/lender if questions arise or if other creditors want to discuss an intercreditor agreement or other negotiation with the secured lender.

**f. Change in borrower entity**

If a new entity takes over as the borrower in a secured transaction, lenders need to determine how perfection can be maintained. N.D.C.C. § 41-09-02(1)(fff) defines "new debtor" as a person that becomes bound as a debtor under a security agreement previously entered into by another person, either by operation of law or contract. This can occur when a new borrower agrees (such as in an assignment) to assume the obligations of the original borrower under the original security agreement or when the original borrower is acquired by, or merged into, a new borrower.

**1. New debtor in same jurisdiction**

As for the collateral existing at the time of the change in borrower, if the new borrower is located in the same jurisdiction as the original borrower, the lender needn't do anything to preserve the perfection of its security interest. However, if after-acquired property is part of the collateral and the difference between the new borrower's name and the original borrower's name would result in a lien search failing to uncover the existing filings, the secured party has four months to file a new UCC-1 financing statement against the new borrower to maintain perfection in collateral acquired by the new borrower after the four-month period.

**2. New debtor in a different jurisdiction**

If a new entity takes over as the borrower as in an assignment and is located in a different jurisdiction than the original borrower, the secured lender must file a new UCC-1 financing statement against the new borrower in the new jurisdiction within one year in order to remain perfected in the original borrower's existing collateral. N.D.C.C. § 41-09-36(1)(c). The UCC allows a one-year period in which to re-perfect because even the most cautious lender may not discover that the collateral has been transferred to a person located in another jurisdiction. (Another good reason to require a covenant requiring the borrower to notify the lender of any changes.) For example, a Harvey, North Dakota corporation that has reincorporated in Omaha, Nebraska is a "new borrower" in a new jurisdiction, even if it continues to use the same name and address because the location of a registered organization is determined by its place of organization rather than its physical address. Also, remember that to remain perfected in after-acquired collateral and any collateral owned by the new borrower prior to the change of jurisdiction, a financing statement against the new borrower must be filed in the new jurisdiction within four months. N.D.C.C. § 41-09-36(1)(c).

Priority of competing claims between the original secured party and existing secured creditors of the new borrower is governed by N.D.C.C. § 41-09-46. As you know, priority under the UCC is generally established in the order the new borrower became obligated under each perfected security interest, so existing secured creditors of the new borrower will probably have priority. The prudent lender should conduct a UCC search on the new borrower to ascertain competing liens.

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