Convert security agreements with care

JOSEPH MCKERNAN

& VICTORIA SAXON

In a cross-border financing, a lender typically will require each U.S. affiliate of a Canadian borrower to grant a security interest in its assets. It is common practice to use a U.S.-law governed security agreement for such U.S. entities.

Because of the desire to maintain contractual uniformity among the various cross-border obligors, the lender's Canadian counsel may ask U.S. counsel to convert a Canadian general security agreement (GSA) into a U.S. security agreement. (In this article, when we speak of Canada or the United States, we are referring to a province or state in generic terms.)

Security agreements used in Canada (other than Quebec) and the U.S. are similar in structure and language. For that reason, it may appear simple to convert a Canadian GSA into a U.S. security agreement. A lender may understand that such conversion process will not necessarily achieve the ideal U.S. security agreement, but conclude that the benefit of uniformity justifies the sacrifice. However, there may be some fundamental negative consequences if a Canadian GSA is not carefully converted.

A granting clause in a Canadian GSA is frequently phrased as follows: "...the Debtor grants to the Secured Party a security interest in all of Debtor's present and after acquired personal property including, without limitation, in [litany of specific categories of collateral]..."

And, a granting clause in a U.S. security agreement might be phrased as follows: "...the Debtor grants to the Secured Party a security interest in [litany of specific categories of collateral] and any other of Debtor's present and after acquired personal property..."

In these two examples, you will notice the difference is the order of phrasing between the specific description of categories of collateral and the catchall generic description, with the Canadian GSA starting with the generic catchall and moving to the specific, and the U.S. security agreement using the reverse order.

Why does this difference exist?

Under Article 9 of the *Uniform Commercial Code* (UCC), for a security interest to attach, the security agreement must include a description of the collateral that is sufficient to reasonably identify the collateral. The *Personal Property Security Act* (PPSA) similarly requires a description sufficient to enable the collateral to be identified. Other than the "reasonably" qualifier in the UCC, the two statutes are virtually the same. What is different is that the UCC includes another provision that states that collateral descriptions, such as "all the debtor's assets," "all the debtor's personal property" or similar supergeneric descriptions do not as a matter of law reasonably describe the collateral for purposes of a security agreement. (This is in contrast to the description of collateral in a financing statement, which may be supergeneric.)

In addition, the UCC expressly approves describing collateral by category using the UCC defined terms, with several exceptions as discussed below. Accordingly, most U.S. security agreements have granting clauses that start with specific categories of collateral using the UCC defined terms and then only use the catchall description at the end. The reverse order, often used in Canadian GSAs, would append the valid description by category to an invalid supergeneric grant. Consequently, the better practice in a U.S. security agreement is to start with the specific categories of collateral.

What is truly critical for Canadian lawyers to understand is that the omission of a particular category in the specific listing of collateral in a U.S. security agreement will result in the secured party not having a security interest in such omitted category. It would be wrong to assume that the omission is corrected by the supergeneric "any other of Debtor's present and after acquired personal property" catchall at the end.

For example, if the granting clause does not cover specifically the debtor's "investment property," either using such UCC term, as is the best practice, or using other terms that have the same meaning, the debtor's investment property will not be covered.

In addition, under the UCC, certain classes of collateral — most importantly, a "commercial tort claim" — cannot be described by category. A common example of a commercial tort claim is a debtor's claim against a third party for contractual interference. Commercial tort claims may have substantial value and can be important assets. Any such claim must be described specifically in a U.S. security agreement.

There are many other legal and practice matters to be considered in converting a Canadian GSA to a U.S. security agreement.

This article is not intended to address all such matters, but to make Canadian lawyers aware that if care is not exercised, the most fundamental purpose of a security agreement may be lost or impaired because the grant of collateral may not be consistent with the lender's expectations. ■

Joseph McKernan and Victoria Saxon, both partners at Hodgson Russ LLP, concentrate their practices in representing borrowers and lenders in secured lending and other transactions, including cross-border financings.