PROTECTING YOUR SHAREHOLDING AND CHATTEL SECURITIES

In the last article we wrote on receiverships and liquidations, and the differences between them. In this article we comment on how funds initially invested into a company can be protected in the event of its collapse, along with related security issues.

The fundamental position with company incorporation is limited liability. This means that the shareholders are not ordinarily liable for the debts of the company; and shareholders' liability is limited to their initial capital investment in the company (for which they take shares in return).

If an initial capital injection of $100,000 is made, the shareholder who made it might like to protect that in the event of the company's collapse.

This advance is usually treated as a loan by the shareholder to the company to allow the company to buy stock (for example) and commence trading. This loan could be repayable on demand and a loan agreement can be entered into between the company and the shareholder.

This loan is, in turn, secured through a security agreement over the company's assets. These assets could be specifically itemised, or usually it is a general security over all of the assets of the company. The latter is preferable. This security is then registered on a searchable register.

The timing of the registration of this security is very important. Subject to a couple of exceptions, registration is based on a first-off-the-rank basis, so it is critical to register the security immediately. If the company then borrows money for capital investment, or for cashflow purposes, the lender is likely to also want security over the company's assets. If the shareholder hasn't registered its security, it will then be forced to register behind the bank and lose priority to the bank. If the company is liquidated, the bank gets first bite at the assets (after IRD and staff wages).

Although the general rule with registrations is outlined above, one exception is a purchase money security interest – or PMSI for short.

A PMSI is a security interest that is taken in goods to secure payment of the purchase price. The best example is what is commonly known as retention of title, where a seller retains title in the goods to secure the purchase money owed on those goods.

If a bank takes security over all of the company's assets and lends money for the purpose of the company making a purchase, the bank will have a PMSI in the goods acquired by that loan so long as it can show the loan was made for the specific purpose of buying those goods.

If a creditor claiming a PMSI has complied with the requirements of the legislation, the PMSI will take priority over other security interests, even if those security interests were registered earlier.

The intention of PMSIs is to allow company borrowers to seek alternative funding when acquiring new goods or assets without the need to execute priority agreements with existing security holders, which include shareholders.