

Can Your Client Be Saved By a Private Receivership?

By Albert S. Frank, LL.B.

The safety of your client's capital and the survival of your client's business could depend on taking a simple precaution.

Suppose your client is a shareholder, or group of shareholders, owning all of the shares of a corporation. Your client puts substantial funds into the business. If the corporation gets into trouble — as could happen even to a well-run operation if there is a recession or some other uncontrollable problem — the registration of security can make all the difference.

Your Client's Security

Your client can fund the corporation by way of a loan. Your client, like any other creditor, may make an agreement to obtain security from the corporation for the loan. Depending on the situation various kinds of security could be available. Debentures, mortgages, and general security agreements are all commonly used.

Most security agreements allow your client, if necessary, to seek repayment of

the debt by appointing a private receiver to take charge of some or all of the corporation's assets. This could include real estate, equipment, trademarks, even the corporation's name.

Your client, subject to the rights of any higher-ranking secured creditor, can have the receiver sell the assets and is then entitled to the proceeds up to the amount owing. Your client's claim ranks ahead of the claims of unsecured creditors, who have no rights over specific assets.

The business is not always liquidated. The assets could be sold to a single buyer. In this way the business could continue as a going concern, free of the former obligations to unsecured creditors.

Of course, the security document must be properly drafted and it must be registered. If the security is not properly drafted and registered, your client should expect to lose its priority over the other creditors.

Is it too late?

Security should be registered at the outset so as to cover the first advance of money to the corporation and all subsequent advances.

If your client has already advanced substantial funds without security, it might or might not be possible to get security for the past advances. The general rule is no security for past advances. Under appropriate circumstances, however, additional funds can be advanced in exchange for security not only over the new funds but also over the past advances.

Appropriate circumstances would not include waiting until the corporation is headed toward disaster and then advancing a token additional sum. Other creditors would likely attack the security as fraudulent, possibly successfully.

To avoid challenges under fraudulent preference and fraudulent conveyance legislation, it is safest to get the security before trouble starts heading the corporation's way.

What if the Bank Ranks First?

If the corporation borrows from a bank, the bank will insist on having its security rank first. If your client already has security, the bank will insist that it be subordinated to the bank's security.

Your client's security is still worthwhile. Even a liquidation could leave something for your client after the bank is paid. Also,

the bank might consent to your client appointing a receiver, who could sell the business as a going concern to a new corporation.

Can Your Client Buy?

But what if your client wants to keep owning or operating the business, which might be quite viable now that the unsecured debt is gone? Can your client be the buyer?

Your client, alone or in combination with new shareholders, can own the new corporation that buys the assets of the old corporation.

This is not guaranteed. The receiver must arrange a sale that is “commercially reasonable,” which could mean a sale to someone else if your client does not offer a good enough price. An auction or public tender process could offer a competing business the ideal opportunity to buy.

If your client offers a reasonable price, though, the receiver will likely accept the offer after doing due diligence including obtaining one or more appraisals of the assets. According to Allan Nackan, C.A., CIP, of A. Farber & Partners Inc.:

very often the assets are worth more to the former owner than they would be worth to an outsider, so the former owner becomes the buyer. We review situations on a case by case basis and we find that the assets do not always have to be advertised, or sold through a public process.

Complexities

There are often many complexities that have to be analyzed to see whether the general ideas set out above can apply. But proper, registered security is the necessary starting point.

Some people put hundreds of thousands of dollars into their corporations, without security. Do not let your clients be among them.

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The above article originally appeared in the April, 2001 issue of ***The Bottom Line***.

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Research has NOT been done to see if this article is still good law. Also, this is general information that might not apply to your particular situation.

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