Lessons for banks from previous recessions

A tsunami of bad debt may be about to wash over the Irish banking system. Tom Murray looks back at previous recessions to see what lessons can be learned

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> *"While the bank does not need the consent of the directors to appoint a receiver, unnecessary legal costs may be incurred if the directors resist the appointment or do not co-operate with the receiver."*

Many banks are now taking rapid steps to beef up the "intensive care" departments that work with customers who are in extreme financial difficulty.

Workouts

The accepted way to work with a customer in financial difficulty is to agree on a workout plan. The likelihood is that the bank will achieve a better realisation on its lending if the directors of the company in question are realistic about the values of the assets and agree on an orderly disposal of them. Alternatively, they may implement a corporate recovery strategy which will enable the business to continue trading and pay off the bank's lending.

Every one knows there are a number of psychological steps to dealing with a crisis and denial is the first. It is critical to the workout process that banks identify when customers are not being realistic, and are desperately trying to save a business which is simply not viable. In these cases the losses will continue to accumulate and possibly erode any security which the bank has. If the bank has doubts as to the bona fides of a corporate recovery plan, they should insist on a firm of independent accountants to report on the plan's viability.

In certain cases, especially where substantial property is involved, it may be in the bank's interest to support an examinership. A major benefit of an examinership of a property company is that the underlying property can effectively be sold, without stamp duty, to a purchaser by allowing the purchaser to acquire the shares.

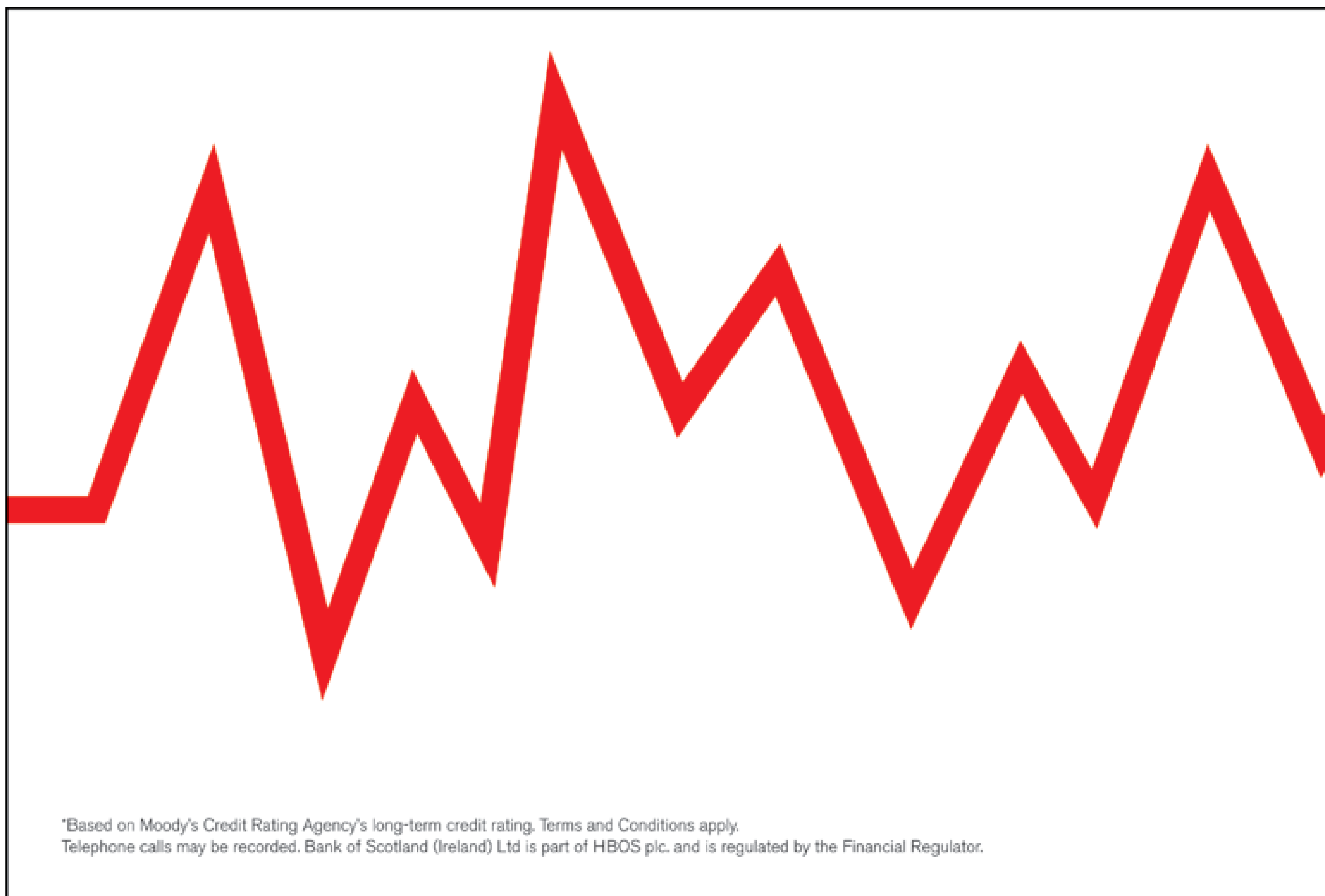
Appointing a receiver

In some cases, a bank may allow a customer to go into liquidation and rely on the liquidator to realise the assets which are the subject of the bank's charge. In other cases, it may be in the bank's best interest to appoint its own receiver. If it is expected that there will be a shortfall on the bank's lending, the bank may minimise the receivership costs by inviting several insolvency practices to tender for the receivership.

In general terms, it is best for the bank to "persuade" the directors of a company to "invite" the bank to appoint a receiver. While the bank does not need the consent of the directors to appoint a receiver, unnecessary legal costs may be incurred if the directors resist the appointment or do not co-operate with the receiver.

Fraudulent preferential payments

There is a natural inclination for directors to pay off a bank's lending before they place the company into liquidation so as to prevent calls on their personal guarantees. Thus, at the liquidation date, the bank may have its lending paid off in full, and may be lulled into a false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sense of security that no further issues may arise. However, the duly appointed liquidator may take steps against the bank for receiving a preferential payment.

One way for a bank to protect itself against a possible fraudulent preferential payment action is to slowly "choke back" the company's lending over a period of, say, six months.

Shadow director

There is an increased probability that a customer that is in "work out" will end up in liquidation, and that the duly appointed liquidator will be obliged to carry out his statutory duties and identify any shadow directors. Accordingly, the bank should take steps that they do not act as a possible shadow director.

Subrogated preferential creditors

Many years ago, banks used to maintain a separate wages account for customers. One of the benefits of maintaining a separate wages account was that, if a company went into liquidation, it was easy for the bank to precisely identify what lending had been used to pay wages, and the bank could make a claim as a subrogated preferential creditor if the liquidator was paying out dividends on preferential claims. While many banks no longer maintain separate wages accounts, it is still possible for a bank to make a subrogated preferential claim in a liquidation, particularly for large payments made for VAT and PAYE within the last twelve months.

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Domino effect

Monitoring the quality of lending to groups of companies can be especially problematic for banks. For example, if a group of companies has a group VAT registration, then the other group companies can be held jointly liable for any VAT liability of an insolvent subsidiary. Such crystallisation of liabilities can have a domino effect on a group.

Negligent valuations

Many banks will have advanced funds on the strength of property valuations. Some of those valuations may look absurd now, and a bank may wish to take legal advice as to whether it has a case of negligence against the valuer concerned.

Guarantees

It is normal for banks to obtain personal guarantees for lending to companies. If it appears that the bank is going to face a shortfall on its lending, then it would be prudent to initiate immediate legal action against the guarantors unless the guarantors come up with immediate settlement proposals.

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