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Locke Lord QuickStudy: Unexpected Rescue: Observations on ?the Silicon Valley Bank Closure and Ongoing Market Disruptions

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Over the past several days, Locke Lord LLP has closely followed the closures of Silicon Valley Bank ?in Santa Clara, California ("**SVB**") and Signature Bank, New York, NY ("**Signature**"), as well as the ensuing ?volatility experienced by many regional banks. We write to provide a general overview as to the ?events triggered by SVB's collapse, and to discuss how depositors, customers, borrowers and other ?affected parties and stakeholders might find themselves positioned—both in connection with the ?receiverships of SVB and Signature, and also in the context of any future depository bank ?insolvencies, closures and receiverships. ?

?***1.? What happened to SVB?*** ?

The dramatic events of the past few days started with a securities filing. On March 8, 2023, SVB ?Financial Group ("**Parent**"), the parent entity of SVB, filed an 8-K with a performance update and ?proposed strategic actions. This filing revealed SVB's sell off of a material amount of securities—?totaling $21 billion—at a substantial loss (largely resulting from the effect of the current interest rate ?environment on SVB's holdings). Thereafter, and in an effort to mitigate recent losses, SVB ?attempted to raise $2.25 billion of equity capital. Faced with these developments, SVB depositors—?heavily skewed toward venture capital and start-up companies—began rapidly withdrawing their ?funds from SVB. A classic "bank run" rapidly ensued. On Friday, March 10, 2023—not more than two ?days following the unexpected securities disclosure—the California Department of Financial ?Protection and Innovation responded by closing SVB and appointing the Federal Deposit Insurance ?Corporation (**FDIC**) as receiver. ?

In conjunction with the closure of SVB, the FDIC chartered a new bank, the Deposit Insurance ?National Bank of Santa Clara, to serve as the initial "bridge bank"—for the purpose of allowing ?depositors access to their insured deposits. On March 13, after a weekend auction failed to produce ?an acquirer for SVB, the FDIC transferred all of SVB's assets to Silicon Valley Bridge Bank N.A., a ?new, full-service and FDIC-operated "bridge bank", offering "normal banking hours and activities . . . ??."?

At the time of the commencement of the receivership on March 10, a substantial amount of ?uncertainty remained with respect to the treatment of uninsured deposits and related financial ?arrangements. According to recent news reports and regulatory filings, more than 93% of SVB's ?domestic deposits were uninsured as of December 31.

The FDIC initially announced that uninsured ?deposit holders would not be allowed immediate access to their funds, and would instead be treated ?as priority creditors receiving an advance dividend within the next week, followed by a receivership ?certificate for the remaining amount of their uninsured funds. The prospect of delay in recovery (or ?potential risk of non-recovery) of uninsured deposits created substantial uncertainty and concerns of ?broader contagion across the rest of the banking sector and the economy.?

The FDIC took a number of actions to address this uncertainty before markets reopened on March 13, ??2023. News reports indicate that the FDIC initiated an auction process for SVB on the night of ?Saturday, March 11, with final bids due on the afternoon of Sunday, March 12. The clear goal of this ?expedited auction process was to find a strong and viable institution to purchase the SVB operating ?assets, and to assume the ensuing obligations to deposit holders. Unfortunately, no bidder for the ?SVB assets emerged over the weekend. Consequently, on Sunday evening, March 12th, the ?Secretary of the Treasury, the Federal Reserve Board and the FDIC took certain interim emergency ?measures to protect depositors, and to stabilize the banking system and the larger economy. Invoking ?their authority under the “systemic risk exception,” Secretary of the Treasury Janet L. Yellen, Federal ?Reserve Board Chair Jerome H. Powell, and FDIC Chairman Martin J. Gruenberg released a ?statement (the “**Rescue Statement**”) announcing that all depositors of SVB would be protected to the ?full extent of their deposits (beyond the already existing deposit insurance), and would be given ?access to their funds on the morning of Monday, March 13, 2023. See here. The statement further ?announced that any losses incurred by the Deposit Insurance Fund would be recovered by special ?assessments on banks. The statement also announced that similar measures were being ?implemented for Signature Bank, New York, NY, which would likewise be closing and placed in ?receivership. ?

??2.? What is the Fed Doing to Protect Depositors in other Banks??

In conjunction with the Rescue Statement, the Federal Reserve Board, with the support of the ?Treasury Secretary, announced the creation of the new Bank Term Funding Program (“**BTFP**”). See ?here. The BTFP offers loans of up to one year of duration to “banks, savings associations, credit ?unions, and other eligible depository institutions” that pledge eligible assets as collateral, which the ?Federal Reserve Board will value at par. This program appears to have been structured to shore up ?the liquidity positions of regional and smaller institutions in the event of substantial deposit ?withdrawal activity, such that depositors would feel more comfortable leaving their deposits in place. ?While the news of the BTFP did not stop the steep market declines experienced by regional banks ?such as Western Alliance, Zions Bancorp, First Republic, and PacWest in trading on March 13, the ?market appeared more tempered by March 14 with the news of the BTFP and the other measures ?taken to protect all deposits at SVB and Signature, but then regional bank stocks and a few larger ?equities began falling again on March 15. Volatility continued on March 16, with the market position ?of Credit Suisse—a much larger institution—experiencing particular stress. We can expect to see ?continued volatility in the banking sector in the short term, as investors absorb recent developments, ?and also assess the impact of these developments on the Federal Reserve Board’s interest rate ?strategy.?

?3.? ? How will deposits be treated? ?

By statute, accounts are insured up to the limit of $250,000 per legal entity customer/individual. Thus, ?in determining how to apply the $250,000 insurance limit—we must focus on a depositor’s ownership ?capacity or legal category of ownership over the account.

If the U.S. Treasury had not intervened to provide full protection for the SVB deposit accounts (i.e., ?making all account funds available, even where the amounts on deposit exceeded the $250,000 ?insurance limit), depositors would only have had access to their deposits up to the $250,000 limit. In ?that event, the uninsured depositors would have had to await the payment of a future dividend and ?then the possible sale or liquidation of the failed bank's assets for an opportunity to achieve a full ?recovery. That prospect entailed significant risk of non-payment or partial payment of the uninsured ?deposit holders. In the event of a liquidation or sale, after the payment of administrative expenses ?and secured claims, the order of priority for distributions from the FDIC as receiver is as follows: (1) ?uninsured deposits, (2) general creditors, (3) subordinated debt holders, and (4) stockholders. ?Fortunately for the SVB depositors, and as provided in the Rescue Statement, these depositors will ?be protected in full and made whole.?

?***4.? ?How does the FDIC treat different types of accounts? ?***

Deposit accounts such as checking and savings accounts, money market deposit accounts, ?certificates of deposit, and other types of cashier's checks or money orders are insured up to the ??$250,000 FDIC insurance limit. It is possible to have deposits of more than $250,000 at one insured ?bank and still be fully insured if the deposits are maintained in different categories of legal ownership ??(e.g., different EIN numbers per account). Careful review of the accounts is warranted.?

Below are certain ownership categories provided by the FDIC:?

- Single accounts owned by one person ($250,000 per owner);?
- Joint accounts owned by two or more persons ($250,000 per owner);?
- Certain retirement accounts, including IRAs ($250,000 per owner);?
- Revocable trust accounts (generally $250,000 per owner per unique beneficiary, but, if there ?are more than five different beneficiaries, special rules apply);?
- Corporation, partnership and unincorporated association accounts ($250,000 per corporation, ?partnership or unincorporated association);?
- Irrevocable trust accounts ($250,000 for the noncontingent interest of each unique ?beneficiary); and
- Employee benefit plan accounts ($250,000 for the noncontingent interest of each plan ?participant).?

Other types of assets—such as stocks, bonds, municipal securities, annuities, crypto assets, safe ?deposit boxes (and contents), life insurance policies, mutual funds and U.S. Treasury bills—are not ?considered deposits covered by FDIC insurance. Consequently, such assets are treated as the ?owner's property, and not as assets of the failed bank. It necessarily follows that the holders of these ?assets will not incur any loss or diminution of their position in the event of a bank closure, ?receivership or failure.?

It is complex and potentially uncertain how to apply these rules in the context of cash sweeps and ?other transfers out of zero balance accounts (accounts that are cleared at the end of the banking ?day). For example, what happens if receivable collections and other receipts—intended to be swept ?and remitted to pay other obligations—are trapped in a zero balance account at the time of a bank ?closure? We could argue that these funds were never intended to be deposited long term at the ?bank, and were only transiting through the institution on their way to another banking destination. ?But the fact remains—these funds could end up on deposit in a demand money market account at ?the time the institution fails. In that instance, the FDIC or receiver could argue that only $250,000 of ?these funds are protected, and the rest of the money becomes a receivership asset. That would ?clearly be a terrible and potentially quite economically significant outcome. Parties utilizing sweeps ?and zero balance accounts in their cash management systems would be well served to give these ?issues careful consideration.?

Accounts held by fiduciaries are insured like ordinary accounts but the $250,000 limit is calculated ?with reference to the beneficiary. The fiduciary and/or beneficiary may need to prove the existence of ?the fiduciary or custodial relationship through documentation unless the name and other records ?associated with the account clearly establish the fiduciary relationship. It will be the account holder's ?burden to prove that fiduciary relationship. It should be noted that insured funds are paid directly to ?the fiduciary for the beneficiary's benefit, and not to the beneficiary directly. If, however, the account ?itself is a fiduciary account and the bank in question is functioning as a trustee or fiduciary, a strong ?argument can be made that the account proceeds should not be treated as assets of a future ?receivership.?

??5.? How will committed but undrawn lines of credit be handled? ?

At this time, it is unclear if and when borrowers will be able to draw on lines of credit provided by SVB ??(i.e., term loans, lines of credit, revolvers and letters of credit). These credit facilities have been ?transferred to the bridge bank and borrowers are requested to contact Silicon Valley Bridge Bank's ?call center for further details.? Moreover, akin ?to a chapter 11 debtor in possession "rejecting" a burdensome executory contract, the FDIC as ?receiver is empowered to "repudiate contracts" such as those that would impede the orderly ?administration of the receivership. 12 U.S.C. § 1821(e)(1). Contracts subject to repudiation include ?lines of credit and also undrawn standby letters of credit that the FDIC views as contingent ?obligations. However, if the FDIC sells the loan as part of a transaction to a healthy acquirer bank, ?the new bank may negotiate to assume the line of credit from the receiver. And if the undrawn line of ?credit is for the benefit of a strong customer with other financing options, the receiver might well ?make the judgment call to honor a draw on the line. All of which is to say—the receiver will likely ?make decisions as to how to handle each open line of credit on a case by case basis, and affected ?borrowers may wish to explore other financing alternatives.?

?***6.? Do I still need to make my loan payments?***?

Borrowers remain obligated to continue making their regular debt service payments on any drawn ?lines in accordance with their loan documents. In most instances, the loan portfolios of a failed bank ?will be transferred to an acquiring bank, at which time the affected borrowers will be notified by the ?FDIC as to where to send payments.?

?***7.? When will the FDIC perform setoffs of loans against deposits?*** ?

As we learned during the Great Recession, the availability of setoff turns on a number of highly ?technical points of law and timing issues, and will depend on the nature and timing of the relevant ?debits and credits, the terms of the underlying loan documents and applicable law. The decision ?whether and when to exercise setoff rights often turns on whether the underlying loan with the ?borrower is performing or in default. The FDIC's guidance states that, for delinquent loans, "the FDIC ?will 'set off' the loan against the borrower's deposits (if any) <u>before</u> paying deposit insurance." For ?performing loans, "the depositor might elect to 'set off' the loan against his/her deposits in order to ?receive full value for any uninsured funds (i.e., funds in excess of the $250,000 insurance limit)." ?However, the FDIC cautions that "no 'offset' is possible unless the obligations are 'mutual' – ?meaning that the borrower and the depositor must be the same person or legal entity acting in the ?same legal capacity." This was a significant issue in the Lehman collapse and should be carefully ?considered in evaluating options.?

?8.? Impact on SVB's parent company, SVB Financial Group, and a potential bankruptcy filing. ?

Since SVB's collapse on Friday, the equity and debt prices for SVB's parent company, SVB Financial ?Group (Parent), have plummeted. The parent has appointed a restructuring committee and hired ?advisors to explore strategic alternatives. These events all point toward a potential bankruptcy filing ?by the parent entity. The filing of a liquidating bankruptcy proceeding—whether under Chapter 11 or ?Chapter 7 of the United States Bankruptcy Code—would result in the immediate halt to all collection ?and litigation activity directed at Parent and likely many of its affiliates by virtue of the Code's ?automatic stay provisions. A bankruptcy proceeding would provide an orderly process for the wind ?down and liquidation/monetization of the Parent's assets. The bankruptcy estate would also be ?empowered to reject unperformed "executory" contracts and pursue "clawback" actions, such as ?preferential transfers made on the eve of bankruptcy or fraudulent transfers made for less than ?reasonably equivalent value. The bankruptcy process could lead to jurisdictional tension with the ongoing FDIC ?receivership process for SVB.[1] For example, pursuant to section 365(o) of the Bankruptcy Code, the ?Parent would have continuing obligations to maintain the capital of SVB, and defaulting on such ?obligations might give rise to an administrative priority claim in Parent's bankruptcy case.?

?***9.? Impact on other Chapter 11 Bankruptcy Proceedings in the United States.*** ?

Many chapter 11 debtors have used SVB as "an authorized depository" bank for maintaining their ?chapter 11 debtor in possession operating accounts. SVB is now disqualified from serving in that ?role. Chapter 11 debtors with SVB deposits, including some cryptocurrency chapter 11 debtors, may ?face delays and other obstacles in the administration of their ongoing chapter 11 cases. ?

Notably, in the chapter 11 case of BlockFi, Inc. (Bankr. D.N.J.), the U.S. Trustee filed a motion Friday ?afternoon claiming that approximately $227 million in deposits belonging to the debtors at SVB are ?uninsured. The motion requests that the court compel the Debtors to comply with section 345 of the ?Bankruptcy Code by posting a bond in favor of the United States. According to the motion, the ?debtors have refused the U.S. Trustee's demands, and have claimed that the funds are invested in ?government securities, earning interest that is necessary for the case. ?

?***10.? Potential Risk Management and Remedial Considerations***

With With the recent and protective actions taken by Treasury and the Federal Reserve Board, and notwithstanding recent and substantial market volatility, we have now entered an interim period in which parties can consider how best to protect their positions and mitigate future risks pending any future insolvencies or failures of other institutions. Here are some issues to consider for parties evaluating their risk profile vis-à-vis their current depository institution:

- Whether a depository bank has a risk profile that has similarities to the risk profile of ?SVB, and if so, what steps may be taken to protect deposit account balances that may ?currently be in excess of FDIC insured limits. ?
- Whether to invest deposits that exceed the FDIC cap in securities.?
- Whether changing a depository institution or cash management system generally ?would impact existing credit agreement covenants that often require a borrower to ?maintain deposit accounts with its lender institution.?
- Whether existing trust and fiduciary relationships should be scrutinized to make sure ?they are appropriately structured and documented.?
- Where existing credit arrangements are committed but undrawn, whether these ?arrangements can be enforced against the existing lenders or, depending on the lender ?replacement provisions, moved to new lenders.?
- Whether these developments in the banking system may affect key customers, ?suppliers, vendors and counter-parties.?
- Whether these developments will impact the ability to complete a capital call if limited ?partners hold their cash or credit facilities with SVB. ?

11. Additional Disclosure Considerations

In addition to the above, public companies and other entities with publicly traded securities should ?consider the disclosure requirements implicated by the SVB situation and its consequences. The ?disclosures, if any, that should be considered will very much depend upon the particular effects of ?the situation on each company. Initially, before the issuance of the Rescue Statement, a number of ?companies disclosed their uninsured deposit circumstances or that they did not have any material ?exposure to the uncertainties created by SVB. These disclosures were triggered by an affirmative ?effort to provide information to the marketplace or to avoid selective disclosure of material nonpublic ?information, including compliance with Regulation FD. With all deposits now being covered for SVB ?and Signature, while companies are free to disclose the absence of exposure to loss, that disclosure, ?even if made privately, should not be considered as required because the information is generic and ?generally available.?

However, that does not mean that there may not be other consequences for the recent bank failures ?that are unique to particular companies and should be considered for public disclosure, either as ?required disclosure, or as voluntary disclosure to inform investors, or to avoid selective disclosure and ?potential violation of Regulation FD. Examples of such adverse consequences could include (i) ?credit lines that have become unavailable, resulting in liquidity problems, (ii) financings for material ?announced transactions that are no longer available and put the transaction in jeopardy, and (iii) ?amendments to existing loan arrangements that were material (for example, to cure a default or permit ?a prohibited transaction) and are now put in question. ?

?12.? I have more questions, where should I turn??

As ongoing volatility in the banking sector continues, and as companies and investors absorb these significant ?events (and the ensuing responses by Treasury and the Federal Reserve Board), the situation continues to evolve on a near daily ?basis. Companies and investors should continue to monitor these developments as they occur, and to consider ?the resulting disclosure and risk mitigation issues, obligations and opportunities. Locke Lord’s experienced and ?integrated restructuring, finance and corporate teams will continue to monitor these developments in real time, ?and to work with our clients to develop appropriate responses, solutions and plans of action. We would be ?delighted to speak with you about specific issues and challenges you may be facing in connection with these ?developments. Please feel free to reach out for any member of our team to start that conversation.?

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[1] The Dodd-Frank Act gives the FDIC extraordinary authority (under specified circumstances) to impose a ?receivership on covered companies that the Secretary of Treasury determines are in default or in danger of ?default. Under section 202 of the Act, no provision of the Bankruptcy Code or of the rules issued thereunder ?shall apply in such cases except as expressly provided in the Act. The Act is comprehensive and contains many ?parallel provisions to the Federal Deposit Insurance Act with respect to the conduct of the receivership and the ?liquidation of the affected bank. The Act also authorizes the creation and operation of a "bridge bank" with ?respect to the receivership assets—for a period of up to five years.?

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