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Impact of Recent Bank Failures on Borrowers, Landlords, and Other Stakeholders

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By Kyle Recker

By now, most will have heard the news that all deposits at Silicon Valley Bank have been made available to depositors. The Federal Deposit Insurance Corporation (FDIC), in a series of joint statements issued with the U.S. Department of the Treasury and the Board of Governors of the Federal Reserve System, announced that all deposits at Silicon Valley Bank – both FDIC-insured and uninsured deposits – have now been transferred to the Deposit Insurance National Bank of Santa Clara, a newly-created bank established by the FDIC.[1]

New York regulators also shut down Signature Bank on Sunday, March 12, 2023, and appointed the FDIC as receiver. Similar to Silicon Valley Bank, both FDIC-insured and uninsured deposits have been transferred to Signature Bridge Bank, N.A., which will be operated by the FDIC as a full-service bank while it is marketed for sale to potential buyers.

The Systemic Risk Exception

The protection of all deposits at Silicon Valley Bank and Signature Bank, rather than only FDIC-insured deposits, was made possible by the so-called "systemic risk exception" (SRE). The SRE was created by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDIC Improvement Act), which prohibited the protection of uninsured deposits if the cost of the resolution of a failed bank to taxpayers would be increased as a result.[2] The SRE allows the FDIC to bypass this limitation by invoking the SRE if the Secretary of the Treasury, with the recommendation of the boards of the FDIC and the Federal Reserve System, determines that there would otherwise be "serious adverse effects on economic conditions or financial stability." On Sunday, the FDIC invoked the SRE for Silicon Valley Bank and Signature Bank.

Bank Term Funding Program

The recent invocations of the SRE specifically apply to Silicon Valley Bank and Signature Bank; it does not mean that uninsured deposits at other financial institutions would be fully protected in the future (unless similar actions are taken). To restore confidence in the liquidity of the U.S. banking industry, the Federal Reserve Board also announced that it is establishing a new program known as the Bank Term Funding Program.[3] Any FDIC-insured deposit institution may borrow funds under the program by depositing certain eligible securities with the Federal Reserve Banks as collateral, which will be valued at par rather than current market value. Advances are available for terms of up to one year, in amounts equal to the par value of the collateral. This will allow financial institutions to temporarily access liquidity equal to the par value of their securities which have lost market value, and currently represent unrealized losses a bank would be forced to realize now if it needed to sell the securities on the market (which essentially is what caused the run on Silicon Valley Bank).

Implications for Non-Depositor Stakeholders

The invocation of the SRE provides relief to impacted depositors, but borrowers, landlords, and other stakeholders of these institutions remain in uncertain positions. Prior to passage of the FDIC Improvement Act in 1991, the typical practice of the FDIC was to retain and manage troubled assets of failed financial institutions itself. But this approach proved to be too costly and complex. Now, the FDIC strategy is to seek a buyer of a failed bank's assets and liabilities as soon as possible, and before a bank actually fails, allowing a different financial institution to continue operations relatively seamlessly from the perspective of depositors and most other stakeholders.

In situations where an acquisition is not immediately possible, there are two key alternatives available to the FDIC. One option is to create a temporary national bank known as a "bridge bank" that can continue normal operations under the FDIC's control while the FDIC markets the bank to potential bidders. The other option is to form a Deposit Insurance National Bank, which is a bridge bank but with more limited operations than a temporary national bank.[4] The FDIC recently utilized both of these options in creating the Deposit Insurance National Bank of Santa Clara (in connection with Silicon Valley Bank) and Signature Bridge Bank, N.A. (in connection with Signature Bank).

It remains possible that the FDIC will find buyers of substantially all of the assets and liabilities of each bank, including their loan portfolios, in the coming days and weeks. As of the date of this publication, HSBC has already been lined up to acquire the operations of Silicon Valley Bank in the United Kingdom (for only £1). But what will it mean for non-depositor stakeholders if no buyers step up soon?

FDIC Servicing of Assets; Contract & Lease Repudiation

It is the FDIC's responsibility to service the assets of a failed financial institution while under receivership until the assets are sold, and it has a number of operational mandates that apply to servicing those assets, such as maximizing the return from their sale, minimizing the amount of realized losses, and preserving availability and affordability of housing for those with low and moderate incomes.[5] It also has broad latitude in determining liquidation strategies, and the power to repudiate contracts and leases entered into by the failed institution before entering receivership.[6] This means the FDIC has the flexibility, within its operational mandates, to elect to terminate outstanding loan commitments, to dishonor letters of credit, and to terminate branch and office leases, among other things.

Borrower Concerns

As noted above, the FDIC is responsible for servicing the assets under receivership until those assets are sold. This includes servicing existing loans and outstanding loan commitments. It is FDIC policy to transfer day-to-day servicing of any retained loans to national servicers within 90 days of the financial institution's failure while the FDIC continues efforts to fully liquidate the institution's loan portfolio. A number of disposition strategies may be used by the FDIC in the liquidation process, including bulk sales and securitization.[7]

To be clear, borrowers should not expect any relief from fulfilling their contractual obligations owed under their credit facilities with a failed financial institution. But on the flipside, given the flexibility the FDIC has to cancel outstanding loan commitments, borrowers should also understand that advances may not be available under lines of credit or construction and development loans. The FDIC will analyze funding requests to determine if a requested advance is in the best interests of the receivership. For example, the FDIC may determine that it is necessary to fund all or a portion of the requested advance in order to preserve the value of collateral or maximize recovery. However, the FDIC's role as receiver generally precludes it from continuing lending operations.[8]

Borrowers also should be aware that Signature Bank provided cash management services in connection with commercial real estate loans as the clearing bank and cash management bank. Lenders may soon be seeking a replacement to Signature Bank if a sufficiently creditworthy buyer does not assume the bank's obligations under the relevant account control and cash management agreements. Some borrowers also may have selected Silicon Valley Bank as a clearing bank, and should also expect that replacement may be required.

Landlord Concerns

While the FDIC has the power to repudiate leases, that does not necessarily mean it will do so for all leases or that it will do so immediately. For example, all Silicon Valley Bank and Signature Bank branch locations are now open for business and operating as branches of the applicable bridge bank under the FDIC's control

and, so long as those branches remain open to the public, landlords remain entitled to contractual rent until such time as notice of repudiation is given. To the extent leases are actually repudiated, landlords will have a claim against the receivership estate for any unpaid rent due as of the date the FDIC was appointed receiver.[9] The extent of recovery for claims for unpaid rent will depend on the extent of funds ultimately recovered by the FDIC from liquidation and made available to various classes of creditors.

Some landlords also may hold letters of credit delivered by tenants in lieu of cash security deposits. As with outstanding loan commitments, the FDIC has the ability to repudiate funding obligations under issued letters of credit. Unless the issuer's obligations are assumed by a purchaser, landlords should not expect that attempts to draw on such letters of credit will be honored and should consider demanding replacements from tenants. Even if the issuer's obligations are assumed, landlords should consider whether the buyer is of adequate credit quality before determining not to require a replacement letter of credit.

Other Stakeholders

Borrowers and landlords are not the only stakeholders aside from depositors that may be impacted by receivership of a failed bank. Other stakeholders include counterparties to swaps and other derivatives transactions, parties to purchase contracts (real property or otherwise), service providers, suppliers, and various other secured and unsecured creditors, as well as investors. But note that the actions being taken by the FDIC and the Federal Reserve in connection with the Silicon Valley Bank and Signature Bank failures are expressly not designed with the protection of investors and unsecured creditors in mind.

The FDIC will establish a process for submitting proofs of claims in the receivership proceedings sometime in the near future, and potential claimants should consult with counsel to preserve their positions within the receivership proceedings as they progress. FDIC receiverships typically are administered in ways that are similar to state court receiverships or bankruptcy cases, but they are not governed by state law or the bankruptcy code.

For questions regarding any potential claims, or assistance evaluating existing credit facilities, leases, and other contracts to determine whether any actions may be appropriate in connection with recent events, please contact Kyle Recker, krecker@coblentzlaw.com, or another member of the Coblentz team.

[1] FDIC press releases may be accessed here.

[2] To read more about the history behind the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, refer to this 2013 article by Noelle Richards of the Federal Reserve Bank of Philadelphia.

[3] A copy of the term sheet for the program is available here.

[4] For a more complete discussion of the FDIC strategies, refer to Chapter 6 of *Crisis and Response: An FDIC History, 2008-2013*.

[5] See 12 USC §§ 1821(d)(13)(E) and 1823(d)(3)(D).

[6] See 12 USC § 1821(e).

[7] See *Crisis and Response*, linked in footnote 4, above.

[8] See *A Borrower's Guide to an FDIC Insured Bank Failure*.

[9] See 12 USC § 1821(e)(4)(B).

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