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It Could Happen Again:

What to Know If There is Another Bank Failure

Prompted by the collapse of Silicon Valley Bank (SVB) on March 10, 2023, depositor fear has spread to thousands of other regional and community banks across the nation, despite extraordinary measures taken by the federal government to stabilize the U.S. banking system.

Should additional FDIC-regulated banks fail, there is no guaranty the FDIC will adopt the same measures it adopted with SVB and Signature Bank (Signature), which entered receivership on March 12, 2023, just days after the commencement of SVB's receivership. As evidenced by recent actions taken to save (at least for the time being) First Republic Bank and Credit Suisse, the banking system remains fragile, and bank customers must remain vigilant.

Below are five things to know in order to navigate another bank failure.

Five Things to Know in Order to Navigate Another Bank Failure

1. What are the FDIC's options to resolve a failed bank?
2. What actions has the FDIC taken in the SVB and Signature receiverships?
3. What could happen in the future if the systemic risk exception is not invoked?
4. How does an FDIC receivership compare to a bankruptcy?
5. What are the risks to certain types of businesses and relationships with a failed bank?

1. What are the FDIC's options to resolve a failed bank?

Upon a bank's failure, the FDIC must decide on a course of action immediately. Under the Federal Deposit Insurance Act (FDIA), the FDIC has a number of methods at its disposal. The most common and preferred method is the consummation of a purchase and assumption (P&A) transaction, whereby a healthy bank acquires some or all of the failed bank's assets and obligations. Another option is a deposit

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payoff, where the FDIC pays insured deposits from the deposit insurance fund and liquidates the bank's assets. The FDIC can also employ open-bank assistance, where the FDIC, instead of establishing a receivership, provides financial assistance to a struggling bank to prevent it from failing.

2. What actions has the FDIC taken in the SVB and Signature receiverships?

The FDIC appears to be using its full arsenal to protect customers of SVB and Signature.

Upon its appointment as receiver for SVB on March 10, the FDIC closed the bank and quickly formed a new entity, the Deposit Insurance National Bank of Santa Clara, to provide access to FDIC-insured funds. Early reports indicated that the FDIC had sold certain loans and assets.

On March 12, it was announced that Signature Bank had failed. Most significantly, that same day, the FDIC invoked the "systemic risk exception" to fully protect SVB and Signature depositors, despite those banks falling below the required asset threshold to be considered "too big to fail." All deposits, insured and uninsured, are available to customers.

- Under the FDIA, the FDIC is required to resolve failed banks in a manner that is least costly to the deposit insurance fund. This prohibits the FDIC from using deposit insurance funds to protect uninsured depositors if it would increase fund losses. The "systemic risk exception" is an exception to the least-cost rule, which applies if compliance with the least-cost rule would have "serious adverse effects on economic conditions or financial stability."

After moving to safeguard deposits, the FDIC took the further step of creating two bridge banks, Silicon Valley Bridge Bank (SVBB) and Signature Bridge Bank (SBB), to assume all insured and uninsured deposits and acquire substantially all of each bank's assets. Both bridge banks are fully-operational, providing former SVB and Signature customers with access to their bank accounts, credit facilities and other banking services.

On March 19, the FDIC announced that Flagstar Bank, N.A. is assuming substantially all of SBB's deposits and acquiring certain of its assets pursuant to a P&A agreement. The FDIC is currently accepting bids for SVBB, as well as for its subsidiary, Silicon Valley Private Bank.

3. What could happen in the future if the systemic risk exception is not invoked?

Without the protection afforded by the exception, the much less protective plan initially announced by the FDIC for SVB deposits would more likely follow:

– Business accounts would be insured up to $250,000 per corporation, partnership or unincorporated association. Depositors would potentially qualify for coverage over $250,000 if they held deposits in different ownership categories established by the FDIC and all requirements for FDIC coverage were met. All deposits in the same ownership category, however, would be aggregated and capped at $250,000.

– Early on, depositors would receive an "advance dividend" on their uninsured deposits, the timing and amount of which would depend on the liquidation value of the bank's assets.

– Depositors would also receive a "receivership certificate" for amounts not paid through the advance dividend, which would give them a claim against the failed bank. The timing of any final resolution or the amount of recovery would likely be uncertain.

4. How does an FDIC receivership compare to a bankruptcy?

Given FDIC receiverships are rare relative to filings under the U.S. Bankruptcy Code, and less commonly understood, it would be wise for customers and counterparties to assume, at least initially, that the FDIC, as receiver, has powers to unilaterally deal with bank assets in ways similar to a bankruptcy trustee. In some respects, the FDIC and federal government have more latitude. For example:

– The FDIC may (i) disaffirm or repudiate any contract or lease if it would be too burdensome, or if repudiation would promote orderly administration and (ii) transfer rights and obligations under a contract, in either case without regard to whether the contract is "executory," as is required under the Bankruptcy Code.

– The priority scheme in an FDIC receivership is similar to that of a bankruptcy case: *Secured claims* **>** *Administrative expenses* **>** *Insured deposits (standard amount of $250k per category)* **>** *Uninsured deposits* **>** *General and senior liabilities* **>** *Subordinate liabilities* **>** *Shareholders*

– The FDIC has discretion to allow or disallow claims, depending on whether they are "proved to the satisfaction of the receiver" and meet certain procedural requirements.

Although a bank is not eligible to file a petition for relief under the Bankruptcy Code, the bank holding company that owns it may and often does file for bankruptcy relief. This materialized in 2008 with respect to Washington Mutual's parent company, which filed for chapter 11 the day after WaMu failed, and more recently with SVB Financial Group, SVB's corporate parent, which filed for chapter 11 on March 17, 2023.

5. What are the risks to certain types of businesses and relationships with a failed bank?

Certain businesses and bank relationships face specific risks when the FDIC takes over as receiver.

Borrowers with revolving credit facilities and other loan agreements

Borrowers may be unable to draw on loan facilities if there is not a swift P&A or sale of the bank's loan portfolio, or if the federal government does not provide assistance, potentially causing a tide of defaults rolling from bank customers to those customers' counterparties who go unpaid.

The FDIC may sell the failed banks' loans, but until a borrower receives notice of a transfer, it generally must continue making payments and cannot terminate or declare a default under any agreement with the failed bank for a period of 90 days after the receivership. Absent extraordinary measures, the FDIC generally does not continue a failed bank's lending operations but will consider exceptions.

Landlords in possession of letters of credit issued by a failed bank

The FDIC has warned in the past that letters of credit (LCs) will not be honored, potentially leaving landlords that accept LCs without security for unpaid rent. Further, a claim under an LC may be considered contingent and not allowed in the receivership, unless a draw was made prior to the commencement of the receivership.

Landlords will need to consider requesting alternative forms of security, such as cash or an LC from another bank (such requests may be authorized by the lease terms).

Issuers of equity and convertible instruments held by the failed bank

Issuers should be aware that without an acquisition of the failed bank or its loan portfolio, equity and convertible instruments issued to the bank in connection with financings could be liquidated in the receivership, subjecting such issuer-borrowers to new, unintended

equity holders. Issues may arise as to the enforceability of transfer restrictions governing such securities and instruments, including with regard to voting rights.

Parties that paid a failed bank within 90 days of the receivership

Transfers within close proximity of the receivership could be subject to clawbacks, such as for the return of fraudulent conveyances. The prospect of a bankruptcy filing or Title II receivership under Dodd-Frank for a failed bank's corporate parent may further increase the risk of avoidance actions under preferential and fraudulent transfer theories. Any intermediary should consider the risk of clawback before paying over to third parties any funds received by a failed bank.

Conclusion

Despite the emergency actions taken by the FDIC and other regulators, there is a crisis of confidence afflicting the banking system. What's more, Treasury Secretary Janet Yellen has cautioned that there is no blanket government guarantee of all deposits. Given that warning, understanding what could happen is critical to protecting yourself against the next bank failure.

For More Information

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