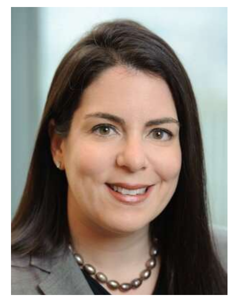
SVB Collapse Highlights Ch. 11 Issues With Bank Holding Cos.

By **Van Durrer, Shana Elberg, James Mazza and Justin Winerman** (April 10, 2023)

Van Durrer



Shana Elberg

James Mazza

Justin Winerman

On March 17, the parent of Silicon Valley Bank filed for Chapter 11 protection in the U.S. Bankruptcy Court for the Southern District of New York.

Unlike SVB, which was put into receivership with the Federal Deposit Insurance Corporation appointed as receiver, SVB's parent, SVB Financial Group, as a bank holding company, was eligible for Chapter 11.

After regulators suddenly closed SVB and Signature Bank, the U.S. government announced that the FDIC will protect 100% of the deposits that clients held at both institutions, including uninsured amounts.

While this allayed depositors' concerns regarding access to their money, the announcement also stated that "[s]hareholders and certain unsecured debtholders will not be protected."

Although the announcement did not specifically identify these unprotected parties, the public holding company's shareholders and parties that have a contractual relationship with the holding company, whether based on funded debt or otherwise, may fall in that category.

Moreover, although SVB Financial asserts in its Chapter 11 case that it holds approximately $2 billion in cash in accounts at the bridge bank set up to step into the shoes of the failed SVB,[1] the holding company stated the FDIC had frozen the debtor's accounts at the bridge bank, and the bankrupt holding company has had trouble gaining access to its books and records, files, electronic systems and key employees.

The FDIC, for its part, objected to the holding company's request for a cash management order — specifically a provision ordering the bridge bank to honor any requests by SVB Financial to transfer the deposited cash to other bank accounts.

The DFIC demurred at the SVB Financial first-day hearing when Chief U.S. Bankruptcy Judge for the Southern District of New York Martin Glenn asked the FDIC if the holding company was carved out of the U.S. government's announcement that all depositors would be made whole.

Instead, the FDIC previewed disputes over jurisdictional primacy between the FDIC, as receiver for the failed bank, and the bank holding company as a debtor under Chapter 11.

For example, the FDIC asserted that the Financial Institutions Reform, Recovery and Enforcement Act and the Federal Deposit Insurance Act effectively trump the U.S. Bankruptcy Code.

The holding company's counsel as well as counsel for an ad hoc group of senior noteholders countered that the Bankruptcy Code, with its broad definition of property of the estate under Section 541, controls the holding company's assets and claims process.

Similarly, when Judge Glenn asked the FDIC if it intended to file a proof of claim in the bankruptcy case, the FDIC's counsel said it was premature to decide whether the FDIC would file a claim, but stated that it has contractual and common law rights to setoff and suggested that any claims should be resolved in the receivership claims process — while the holding company and its creditors will be looking to resolve claims against it in the bankruptcy case.

These and other issues will likely play out in the bankruptcy case.

It is important for bank holding company boards and management, distressed debt investors, including those with potential claims against the parents of failed banks, and regulators to understand the distinct rules and issues in bank holding company bankruptcies.

This is especially true in the wake of the recent banking turmoil and given that there are often operational entanglements — e.g., intercompany agreements and shared services— between a bank and its parent holding company.

In particular, several provisions in the Bankruptcy Code grant federal regulatory agencies like the FDIC significant advantages relative to other creditors. Thus, as described below, disputes involving capital commitments and tax refunds often surface in these cases.

Below are significant distinguishing features of bank holding company Chapter 11 cases.

Section 365(o): Deemed Assumption of Capital Commitments

Section 365(o) of the Bankruptcy Code is the most noteworthy deviation from typical Chapter 11 convention.

This provision departs from the default rule that gives a debtor the option to assume or reject executory contracts by automatically deeming to be assumed any commitment by the bank holding company with a federal depository institutions regulatory agency — e.g., the Federal Reserve, Office of Comptroller of the Currency or the FDIC — to maintain the capital of an insured depository institution.

The commitment by the holding company would most likely stem from its obligation to serve as a source of strength — i.e., an obligation to provide financial assistance to its bank subsidiary in the event of the financial distress of the bank.

As a result of this automatic assumption, the debtor holding company must also immediately cure any deficit under any such a commitment, or its bankruptcy case will be converted from Chapter 11 to a Chapter 7 liquidation proceeding in which a trustee is appointed to liquidate the debtor's assets.

In such a case, FDIC claims relating to valid capital maintenance obligations will come ahead of general unsecured claims — e.g., unsecured funded debt at the bank holding company as well as the bank holding company's shareholders.

Section 365(o), however, does not define a commitment. Thus, whether a valid, enforceable commitment exists becomes an issue for bankruptcy court interpretation, based on the evidence.

Several bankruptcy courts have examined whether particular communications or undertakings constitute valid, enforceable contracts and thus whether they constituted the sort of capital maintenance obligation envisioned by Section 365.

In two cases, courts found no enforceable commitment:

- In re: The Colonial BancGroup in the U.S. Bankruptcy Court for the Middle District of Alabama in 2010, holding that bank holding company did not make a commitment to maintain the capital of its bank subsidiary; and

- In re: AmFin Financial Corp. in the U.S. Bankruptcy Court for the Northern District of Ohio in 2011, holding that the FDIC failed to present sufficient evidence that either the regulator or the holding company understood or intended for the documents at issue to create a commitment by bank holding company to maintain the capital of its former bank subsidiary.

In two other cases, courts held there was an enforceable obligation:

- In re: Imperial Credit Industries Inc. in the U.S. Court of Appeals for the Ninth Circuit in 2008, finding a holding company's performance guaranty constituted a capital maintenance obligation under Section 365(o); and

- In re: Overland Park Financial Corp. in the U.S. Court of Appeals for the Tenth Circuit in 2001, finding holding company's stipulation in writing to regulator that it would maintain net worth of savings and loan subsidiary constituted a commitment for purposes of Section 365(o).

Notably, Section 616 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended the Federal Deposit Insurance Act in an attempt to bolster the FDIC's argument that holding companies are committed to maintain the capital of their distressed bank subsidiaries by codifying the source of strength doctrine previously included in the board of governors of the Federal Reserve System's regulations.

But it is likely that bankruptcy courts will continue their facts and circumstances review to see if any specific document(s) creates an actual commitment for purposes of Section 365(o).

Thus, early assessment of any potential capital commitment can be a pivotal issue in a bank holding company's Chapter 11 case.

Section 507(a)(9): FDIC Priority Claims

In addition to the deemed assumption of capital maintenance obligations under Section 365(o), the FDIC and other federal depository institutions regulatory agencies may assert entitlement to priority status for any unsecured claims resulting from such commitments, which could give the FDIC and similar agencies an extra layer of protection even if a case is converted to a Chapter 7 liquidation.

Priority claims are required to be paid in full before other general unsecured nonpriority claims and could result in reduced recoveries to those that have unsecured claims against the bank holding company, as well as holding company shareholders.

Bank Holding Company Asset Maximization

A bank holding company may have a variety of assets under its corporate umbrella outside the failed bank.

It may own other subsidiaries operating otherwise healthy businesses — e.g., an investment bank, brokerage or even a car wash.

The bank holding company may also have rights to other property such as tax refunds. In the typical bank holding company structure, the parent holding company and bank entity are counterparties to a tax-sharing agreement that memorializes these entities' rights to tax refunds.

Upon the bank's failure, disputes between the holding company and the bank over tax refunds are fairly common.

Often, these cases turn on the particular language in the tax-sharing agreement between the bank and its parent, and whether such language creates a debtor-creditor relationship, in which case the holding company is likely to own the refund, or, alternatively, a trust, bailment or agency relationship, in which case the bank — and the FDIC as receiver — is likely to own the refund.

The vast majority of tax refund ownership dispute cases between a bank holding company and the FDIC have settled.

Others were litigated to judgment with mixed results — i.e., the holding company winning some and the FDIC others, depending on, among other things, the language in the applicable agreement.

Notably, in 2014, in response to these disputes, the FDIC updated its interagency policy statement to "ensure that tax allocation agreements explicitly acknowledge that an agency relationship exists between a holding company and its subsidiary institution with respect to tax refunds attributable to the institution."[2]

To the extent parties complied and updated their tax allocation agreements, courts may find the parties' intent weighs in favor of the bank.

Implications for SVB Financial and Other Holding Company Bankruptcies

As noted above, the FDIC has announced it will fully protect uninsured and insured depositors from any losses on their deposits at SVB.

SVB Financial asserts it has approximately $2 billion on deposit at SVB's bridge bank set up in the wake of the bank failure.

Yet, the FDIC may be considering asserting any claims against the failed bank's former parent, including capital maintenance obligation claims and rights to setoff.

The bank and its former parent had many other intercompany relationships — on both the asset and liability side — and those will all be closely examined once they are able to be untangled as their outcome could have a large impact on how the holding company's creditors and shareholders fare in Chapter 11.

Van C. Durrer II is a partner and leads the western U.S. corporate restructuring practice at Skadden Arps Slate Meagher & Flom LLP.

Shana E. Elberg is a partner at the firm.

James Mazza Jr. is a partner at the firm.

Justin M. Winerman is counsel at the firm.

Skadden partner Ron Meisler, and associates Robert Fitzgerald and Brad Lenox, contributed to this article.

[1] The FDIC recently announced that it entered into a purchase and assumption agreement for all deposits and loans of SVB, by First–Citizens Bank & Trust Company, Raleigh, North Carolina.

[2] Tax refunds were of particular focus during the last set of bank failures, because then President Obama had signed into law the Worker, Homeownership, and Business Assistance Act of 2009 that, among other things, extended the use of net operating losses (NOLs) carrybacks so that taxpayers were eligible to carryback an NOL to the previous five taxable years rather than the traditional previous two taxable years under prior law. NOLs and tax refunds will still have an impact. Notably, counsel for a distressed investor in SVB Financial's Chapter 11 case has already asserted at the first-day hearing that the debtor will have substantial tax assets and that they could be the most valuable asset of the estate. To that end, the bankruptcy court already approved the holding company debtor's motion to establish procedures to preserve the NOLs and other tax assets.