Client Alert: Silicon Valley Bank Closure Impact on Lease Security

BY PAUL C. BAUER • MARCH 13, 2023

The impact of the California Department of Financial Protection and Innovation taking possession of Silicon Valley Bank (SVB) and appointing the Federal Deposit Insurance Corporation as receiver for SVB is receiving thorough media coverage. The FDIC has formed Deposit Insurance National Bank of Santa Clara to serve as a "Bridge Bank" to provide customer access to certain deposit accounts and to facilitate the liquidation of SVB. A more specific impact relating to the real estate industry, however, is worth noting.

SVB is well-known for its startup focus in the technology and life science world. When leasing real estate to startup companies that do not have cash flow, landlords typically require security deposits that can range from small five figures to millions of dollars depending on the tenant improvements and other cash outlays that the landlord may invest in the property. For mid-size and larger security deposits, both landlords and tenants often prefer that the tenant obtain a letter of credit for the security deposit rather than posting cash.

A letter of credit is basically the obligation of the issuing bank to advance up to a certain amount of funds to a third party, here the landlord, if the tenant defaults on its lease obligations. The letter of credit is sometimes cash collateralized by a segregated deposit account set up by the tenant with the issuing bank. The landlord can draw on the letter of credit after an event of tenant default. A tenant may obtain a letter of credit for $100,000, for example, which the bank issues to the landlord to secure the tenant's performance. Typically, the tenant will work with its primary bank to provide a letter of credit to its landlord. As many startup companies bank with SVB, there are many, many letters of credit issued by SVB out there as security for commercial leases.

With SVB now in receivership, what does this mean? A landlord holding a letter of credit issued by SVB will not be able to draw upon the letter of credit as the FDIC determines its next steps to address SVB's obligations in connection with loan portfolios and uninsured deposits. It is possible that another entity will acquire most of SVB's banking assets or that the FDIC will opt to sell portfolios of SVB loans, with the collateral securing the loans continuing to secure the loans being sold. Under these scenarios, existing letters of credit would presumably continue to secure leases.

The FDIC and the Federal Reserve have taken the extraordinary step of supporting all deposit accounts at SVB, but at least in the joint statement there is no indication that this protection will be extended to the holders of letters of credit issued by SVB. In the FDIC's initial FAQ regarding the SVB liquidation, the FDIC stated that it may be possible for the Bridge Bank to offset the uninsured amount of a customer's deposits against a loan in the same name as the name of the uninsured deposit account. This might provide a way for a landlord holding a letter of credit that has been cash collateralized with SVB by the tenant to draw upon the letter of credit. The FDIC suggests making a telephone appointment with an FDIC Claims Agent at 1-866-799-0959 to discuss these sorts of situations.

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While we wait to see what happens in the next couple of days, landlords and tenants on leases secured by SVB letters of credit should take preliminary actions. Landlords should first review their leases. In most instances, the lease will provide for a process in which the landlord can demand replacement of the letter of credit by a new letter of credit or cash. (In fact, most leases provide the landlord with the right to draw on the letter of credit if the credit worthiness of the *bank* falls below certain thresholds, but here SVB failed so spectacularly quickly that it is unlikely that many landlords drew on the letters of credit before SVB failed.) Landlords can then begin working with tenants to obtain replacement letters of credit. The timing on substitution letters of credit may not be as quick as required by the typical lease due to the impact SVB's closure may have on companies' financial accounts. If it does not appear likely that the tenant can provide a substitute letter of credit or other satisfactory credit enhancement for the lease, the landlord should review options with counsel as to whether a receivership claim is worthwhile as this is not a clear path to recovery under the SVP letter of credit.

Tenants that used SVB for letters of credit in most instances have their accounts with SVB and are already laser focused on what the receivership means to them and their businesses. When reviewing the impact of the SVB receivership, tenants should determine whether there are any letters of credit outstanding that will also need to be addressed. Tenants should be prepared to engage with their landlords to work through the process of confirming the landlord has the security provided for under the lease. Of course, where tenants are sustaining major financial dislocations from the receivership, discussions with landlords may need to address financial accommodations more globally rather than being limited to letter of credit substitutions.

The impact of the SVB receivership could have a material impact on the commercial real estate world so we will wait and see whether the FDIC can broker an acquisition that protects a lot of companies and an even broader range of stakeholders.

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