

ANDERSON KILL

Bankruptcy & Restructuring Alert

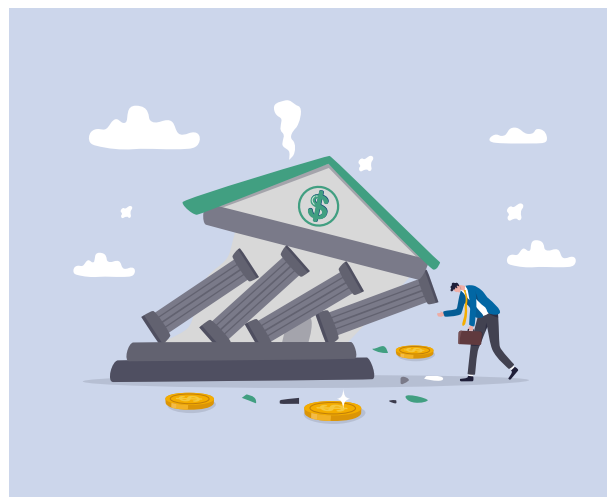
Back to the Future with Silicon Valley Bank



By Mark D.
Silverschotz

“History never repeats itself, but the Kaleidoscopic combinations of the pictured present often seem to be constructed out of the broken fragments of antique legends.” So wrote Mark Twain (with co-author Charles Dudley Warner) in *The Gilded Age: A Tale of Today* (1873, Chapter XLVII). In that regard, to any attorney practicing bankruptcy law during the mid-1980s [raises hand], the recent travails of Silicon Valley Bank (“SVB”) and Signature Bank (NY) contain more than a few of the Twain/Warner “Kaleidoscopic combinations”.

Those two institutions were hit with bank runs. As has been widely described elsewhere, the runs were propagated by 1) certain financial analysts noticing that the bank’s medium and long term Treasury holdings had become devalued as a result of the Federal Reserve hiking interest rates, and 2) in SVB’s case, the reported direction by Peter Thiel’s Founders Fund to its portfolio companies to remove their deposits from those banks. The FDIC’s takeover was a consequence of the failure by those banks to properly hedge against the run-up of interest rates, either by going into the futures market or through other means of effective financial planning. SVB’s attempted solution — to first partially liquidate at a loss its Treasury portfolio



and then go into the equity market to raise additional capital ... did not work.

To this point, on March 28, Michael S. Barr, the Federal Reserve’s Vice Chair for Supervision testified before the Senate Committee on Banking, Housing, and Urban Affairs. He was specific, noting in his written statement that “the bank [SVB] did not effectively manage the interest rate risk of those securities or develop effective interest rate risk measurement tools, models, and metrics.”

A Familiar Path to Insolvency

In 1984 Anderson Kill represented the creditors committee in the Chapter 11 case of Lion Capital Group. Lion made a market in what was then a re-introduced financial product known as a “repurchase agreement” or “repo”. Today most sophisticated financial pro-

fessionals — including bankruptcy lawyers — are familiar with repos and the safe harbors within the so-called “repo amendments” to the Bankruptcy Code contained in the Bankruptcy Amendments and Federal Judgeship Act of 1984 (Pub. L. No 908-353, 98 Stat. 333, effective July 10, 1984) (more commonly known as “BAFJA”).

If you’ve been following the SVB case, Lion’s path to insolvency may sound familiar. Lion’s management was guilty of failing to hedge its long securities positions held in various forms of governmental or quasi-governmental (Fannie Mae and Ginnie Mae) bonds. Rates went up. Values went down. When it was time to close out the repos Lion had sold, there wasn’t enough money to go around. Added to that, Lion had purported to use those bonds as collateral for its borrowings, so that both the repo “purchasers” of the securities (the committee’s constituents) and the lender (Bradford Trust Company) fought over whose claims had primacy. The case ultimately settled with creditors receiving somewhere in the neighborhood of eighty percent of their claims. Much of Lion’s history is at *In re Lion Capital Group*, 49, B.R. 163 (Bankr. S.D.N.Y. 1985), in which, to the combined chagrin and outrage of the case professionals, the bankruptcy court initially rejected the parties’ universal settlement. Notably, certain members of Lion’s senior management went to jail, having falsely represented the company’s solvency to prospective investors. See *Two Plead Guilty in Lion Case*, New York Times, May 21, 1985, Section D. Page 27.

During the litigation with Bradford Trust, I had the privilege of defending the depositions of several dozen of the committee members which were Lion’s

transactional counter-parties, nearly all of which were New York State school districts. In preparing our witnesses my colleagues and I were stunned to learn that not only had they invested with Lion, but the bulk of them had engaged in equivalent transactions with other “repo” firms, including Bevill, Bresler & Schulman (“BBS”) and ESM Government Securities (“ESM”). The clients quickly unwound (or did not renew) those transactions and both entities similarly ended up in Chapter 11. An excellent early history of the repo market collapse can be found at Joseph G. Fallon’s *The Government Securities Act of 1986: Balancing Investor Protection with Market Liquidity*, 36 Catholic Univ. Law. Rev. 999 (1987)(“Fallon”). There, Fallon notes that the losses at BBS were estimated at \$300 million and up to \$236 million at ESM. *Id.* at 1008-09. Small potatoes compared to the billions lost at SVB and Signature Bank, but devastating to the small investors that sustained losses. Further, the ESM debacle lead to the collapse of Home State Bank and the “S&L Crisis” of the mid-1980s.

Notably, however, as new, corrective legislation was drafted, Fallon observes that:

Many participants sought greater regulation to maintain the integrity of the market and, therefore, to increase its liquidity. Oddly, a **fear of reduced market liquidity caused other market participants to oppose regulation, claiming that the market will correct itself.** However, this position offers nothing in the way of preventive action. Future problems are not adequately addressed merely because the market has been able to adjust to current problems. As one SEC Commissioner stated, ad

“Market risk is closely related to credit risk. Suppose a dealer is unable to meet obligations at the maturity of a repurchase agreement. An investor who has taken proper steps to gain control of securities is likely to retain that control. However, the important question is whether the value of the securities is sufficient to cover the cash provided by the investor and the interest he earned.”

hoc corrections would not allow for flexible responses, let alone encourage smooth and efficient market operations.

Id. at 1012 (footnotes omitted)(emphasis supplied). See also, Garbade, *The Evolution of Repo Contracting Conventions in the 1980s*, Federal Reserve Bank of New York Policy Review, May 2006.

The history of the BBS case is exhaustively set forth in *Matter of Bevill, Bresler & Schulman Asset Management Corp.*, 67 B.R. 557 (D.N.J. 1986), and that of ESM (more concisely) at *In re ESM Government Securities, Inc.*, 52 B.R. 372 (S.D. Fl. 1985).

Old Lessons Not Learned

In August of 1986, the General Accounting Office (GAO), in response to Congressional inquiry, gave a tutorial in *Briefing Report to the Chairman, Subcommittee on Domestic Monetary Policy, Committee on Banking, Finance and Urban Affairs, House of Representatives* (entitled *U.S. Treasury Securities: The Market's Structure, Risks and Regulation*). One relevant portion reads:

The principal risk dealers and their customers face in the Treasury securities market is market risk, which also exists in all other securities markets. Subsequent sections describe other risks that are also present in the market — credit risk, business risk, and unexpected changes in the institutional structure of the market.

Market risk arises from gains or losses due to fluctuations in market prices of Treasury securities. The prices of Treasury securities are inversely related to yields. **The price of a Treasury security will rise when the market interest**

rate for securities of equal maturity falls. Conversely, the price will fall when the market interest rate rises. Prices of longer term securities are more sensitive to a given interest rate change than are shorter term ones.

Id. at p. 40 (emphasis supplied). To which, we can only say, “well, yeah.”

Lastly, repurchase agreements were the topic of a “Special Issue” of the Federal Bank of Atlanta’s *Economic Review* of September 1985. There, in the shadow of the Lion, BBS, and ESM debacles, is *Identifying and Controlling Market Risk*, by Sheila L. Tschinkel, then the Atlanta Fed’s Senior Vice President and Director of Research. The opening paragraphs are as follows:

Repurchase agreements involve risks even though the government securities used to collateralize them are risk-free. One important risk derives from fluctuations in the market value of the securities, particularly when agreements are outstanding for several days. What is market risk, and what steps can investors and those using repos to raise funds take to identify and control this risk?

Market risk is closely related to credit risk. Suppose a dealer is unable to meet obligations at the maturity of a repurchase agreement. An investor who has taken proper steps to gain control of securities is likely to retain that control. However, **the important question is whether the value of the securities is sufficient to cover the cash provided by the investor and the interest he earned. Investors thus must protect themselves against the risk**

Forty years of history in the repo market should have made clear that financial institutions with material short term liabilities ought not have put the bulk of their net worth into unhedged long term assets. The Fed knew this. The GAO knew this. Congress knew this. Bankruptcy lawyers knew this.

of fluctuations in market prices by initially requiring a margin above the value of the cash provided. They also need to monitor these values during the term of the repo to make sure that they are still protected. Their agreement should specify when margin calls can be made, the time that a counterparty has to meet them, and how they can be met—whether with cash or securities.

Customers who have done reverse repos, exchanging securities in their portfolios for cash, will still have the cash if a dealer cannot return their securities. However, they will suffer a loss of margin given if the securities have increased in value during the life of the agreement or if interest accruals on them exceed the amount they owe the dealer for funds they provided. Therefore, when doing a reverse, they should strive to minimize the margin given. Their agreements should also be specific with regard to margin calls and payments. Moreover, since they have typically provided margin, they need to know at the outset if the potential loss of margin is tolerable.

In addition, certain financial institutions may suffer a balance sheet loss larger than that of the margin

given if the market price of the securities under repo is below the book value of the securities.

Id. at 35-36.

What (hopefully) is clear from nearly forty years of history in the repo and other securities markets is that any institution with short term liabilities (such as, perhaps, depositor withdrawal rights) ought not put the entirety of their net worth in long term assets. The Fed knew this. The GAO knew this. Congress knew this. Bankruptcy lawyers knew this. Maybe eventually the finance industry will learn. ▲

MARK D. SILVERSCHOTZ, co-chair of Anderson Kill's Bankruptcy & Restructuring Practice Group, has worked in the bankruptcy and reorganization field since 1981, representing secured, unsecured, and subordinated creditors, debtors-in-possession, and official committees of creditors and equity holders. Mark also has served as special insurance counsel in multiple bankruptcies stemming from asbestos and other toxic tort liabilities, including the LTL (Johnson & Johnson spin-off), Cyprus Mines, Kaiser Gypsum, Celotex and Dow Corning cases, among numerous others.

msilverschotz@andersonkill.com
(212) 278-1870

***We are
interested in
your feedback
on topics for
future articles
and seminars.
Please email
us.***

About Anderson Kill

Anderson Kill practices law in the areas of Insurance Recovery, Commercial Litigation, Environmental Law, Wills, Trusts and Estates, Corporate and Securities, Antitrust, Banking and Lending, Bankruptcy and Restructuring, Real Estate and Construction, Foreign Investment Recovery, Public Law, Government Affairs, Employment and Labor Law, Captive Insurance, Intellectual Property, Corporate Tax, Hospitality, and Health Reform. Recognized nationwide by Chambers USA, and best-known for its work in insurance recovery, the firm represents policyholders only in insurance coverage disputes — with no ties to insurance companies and has no conflicts of interest. Clients include Fortune 1000 companies, small and medium-sized businesses, governmental entities, and nonprofits as well as personal estates. The firm has offices in New York, NY, Newark, NJ, Philadelphia, PA, Washington, D.C., Stamford, CT, Los Angeles, CA, Denver, CO, and Boston, MA.

This publication was prepared by Anderson Kill P.C. to provide information of interest to readers. Distribution of this publication does not establish an attorney-client relationship or provide legal advice. Prior results do not guarantee a similar outcome. Future developments may supersede this information. We invite you to contact the authors with any questions. © 2023 Anderson Kill P.C.