

# Silicon Valley Brawl: Litigation, Accounting, and Regulatory Implications of SVB's Collapse

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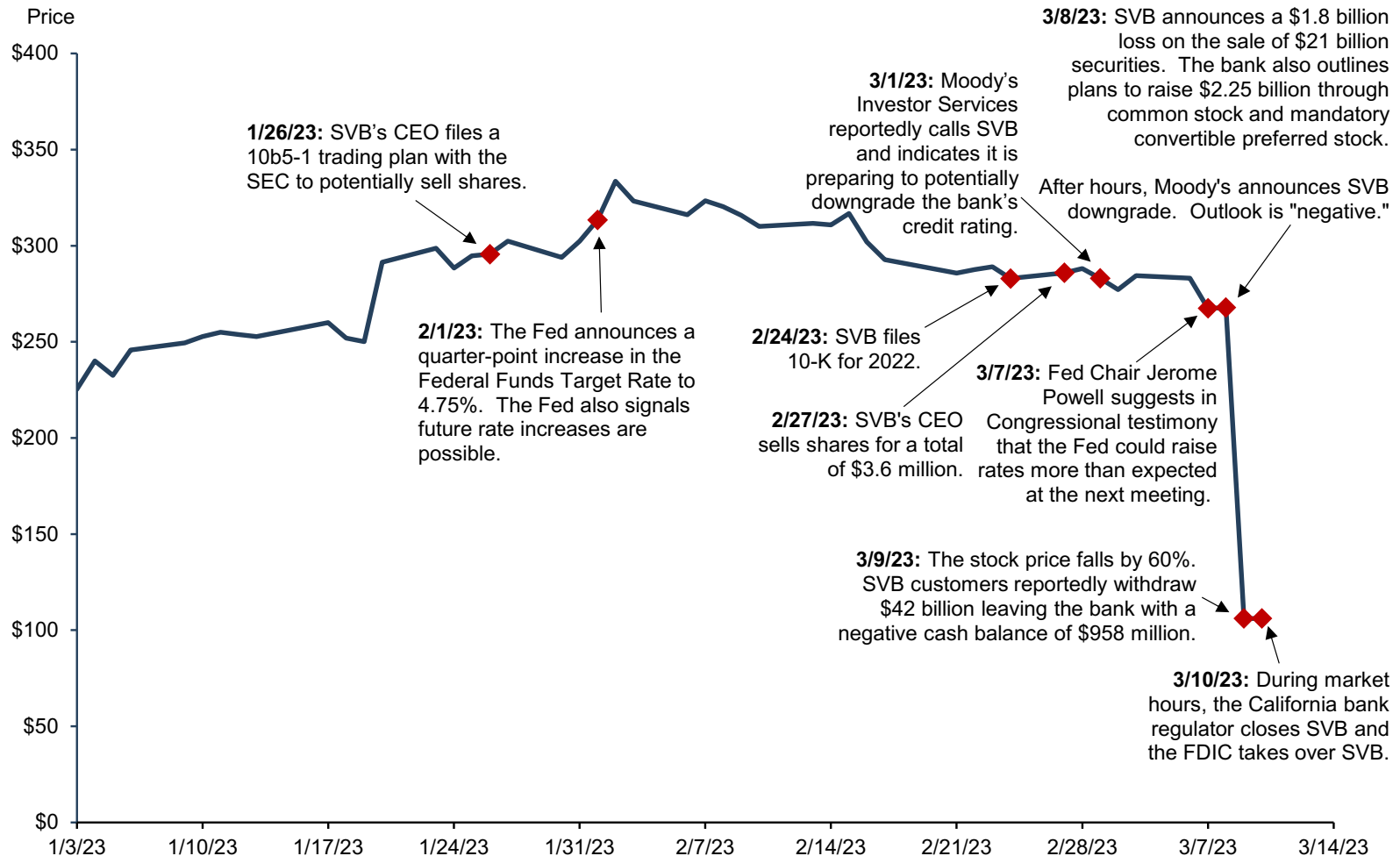
## Preliminary, Cautionary Notes

- This deck is descriptive. It is offered for discussion purposes only.
- This deck does not endorse any plaintiff or defense theory or regulatory reform described herein.
- This deck is materially incomplete. Many plaintiff and defense theories and regulatory reforms are not addressed in this deck.
- This deck speaks as of March 20, 2023, and, given the pace of current developments, will quickly be overtaken by evolving events.

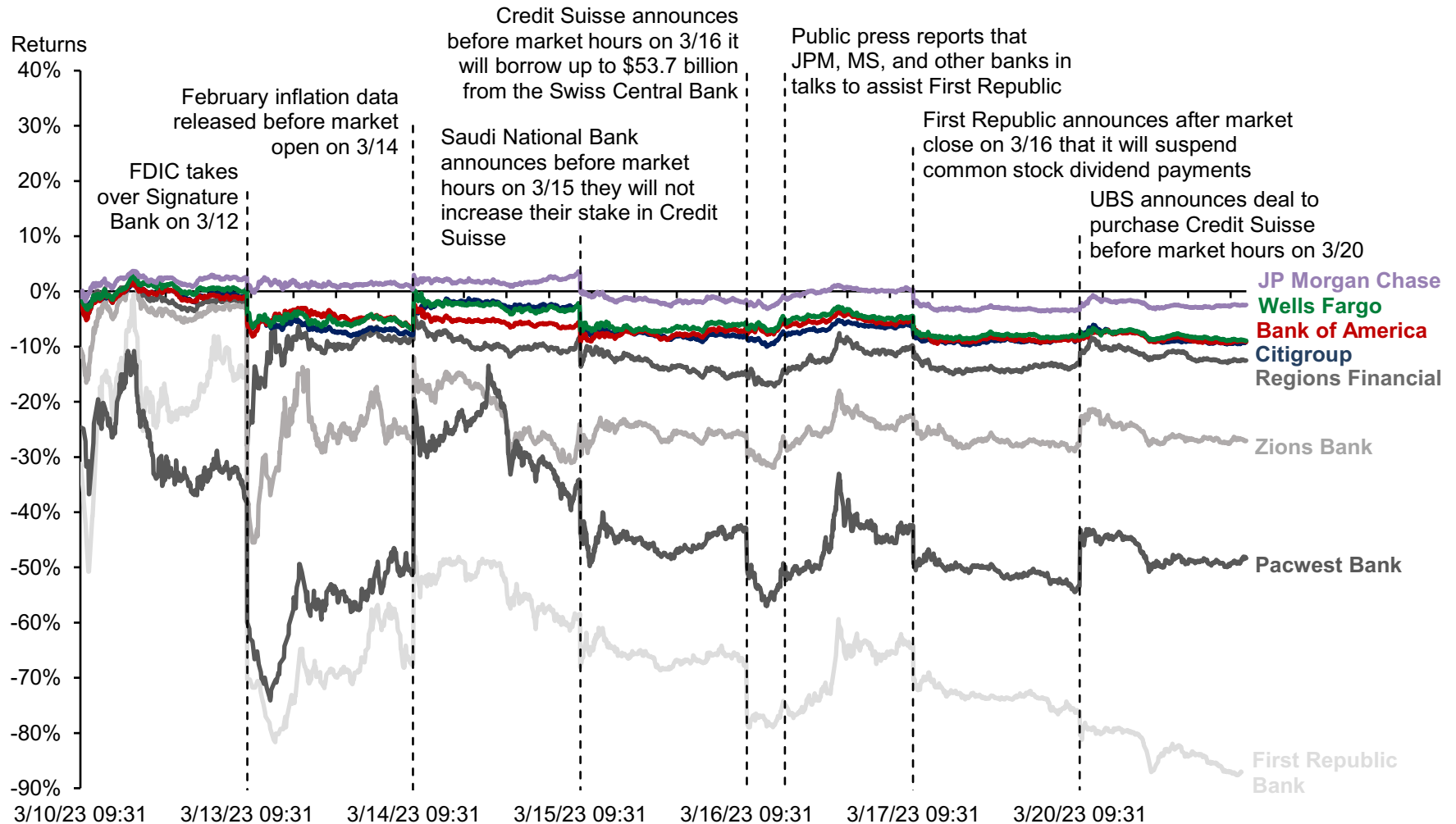
## Outline: Looking Ahead

- The litigation mosh pit
- SVB's accounting and opportunities for improved disclosure
- Opportunities for improved treasury procedures
- Public policy implications
  - A new regulatory paradigm?
  - Is deregulation to blame?

## SVB Financial Group Closing Stock Price and Selected Events 1/3/23 – 3/14/23



## Returns of “Too Big To Fail” Banks vs. Regional Banks 3/10/23 – 3/20/23



Source: Refinitiv; Public press

Note: Cumulative returns are depicted from 16:00 ET on 3/9/23.

## *Litigation Dramatis Personae*

- DOJ, SEC, Federal Reserve Bank of San Francisco, Federal Reserve (DC), FDIC and state agencies have already announced investigations.
- Congressional hearings scheduled for March 29.
- Private party class action securities fraud claims are already on file.
- Section 220 demands as precursors to derivative litigation have either already landed or will soon do so.
- Probable defendants:
  - The bank holding company, SVB Financial, is now in Chapter 11.
  - Officers and directors
  - Auditors (KPMG)
  - Advisors (Goldman Sachs)
  - The target: the D&O policy, but how much will be left for plaintiffs given likely litigation expenses?

## The Holding Company is Bankrupt

- The publicly traded shares were of the holding company now in Chapter 11.
- The FDIC has strong claims to remaining assets, though there can be a battle over those assets.
- Claims against the publicly traded entity will thus generate unsecured claims in bankruptcy that could be worth substantially less than face value.
- How will the bankruptcy stay affect shareholder and derivative litigation?
- What happens to the indemnification agreements?
- What happens to the insurance policy? Will lawyers eat it all?
- Are officers and directors at greater personal risk because of the bankruptcy?
- Will this evolve into one of the rare cases in which officers and directors actually incur personal liability?

## Categorizing Plaintiff Claims

- Three distinct categories of potential claims appear to dominate.
- Price inflation claims
  - Material omissions and misrepresentations caused SVB stock to trade at an inflated value.
  - These price inflation claims do not require proof that defective disclosure or mismanagement caused the collapse.
- Collapse causation claims
  - Actionable mismanagement and/or defective disclosure caused the bank's demise.
- FDIC claims
  - Claims of negligent management that are uniquely prosecutable by the FDIC.



## Potential Plaintiff Claims (1 of 5)

- Experience teaches that plaintiffs can often add claims and introduce further precision as discovery and time progresses.
- The characterization of plaintiff claims in this deck is based on current publicly available information and is therefore likely underinclusive.
- The authorities will build detailed chronologies mapping communications between bank insiders, clients, regulators and others.
- There will be massive document discovery.
- There will be significant public pressure to assign blame for the bank's demise. That pressure has already begun.
- Intriguingly, the effort to assign blame has two very different trajectories. One points to officers and directors. The other points to regulatory failure.
- The litigation implications of the two are very different. Regulatory failure can act as a litigation defense for officers and directors.

## Potential Plaintiff Claims (2 of 5)

- The Fed repeatedly warned SVB of risk control lapses, was “doing a bad job of ensuring that it would have enough easy-to-tap cash on hand in the event of trouble,” was “deficient for governance and controls,” and was relying on “bad models” to test its portfolio response to interest rate increases. NYT 3/18/23.
- SVB was without a chief risk officer for much of 2022. Bloomberg 3/16/23.
- “Blackrock’s consulting arm warned SVB... that its risk controls were ‘substantially below’ its peers in 2022.” FT 3/17/23.
- “Silicon Valley Bank lost a crucial day to raise money from investors after its board rejected executives’ financial projections, leading to a chaotic and ultimately doomed scramble for cash,” Semafor, 3/17/23.
- Were these matters timely and accurately disclosed and were they material?
- Did they cause the bank’s failure?
- Even if they didn’t cause the bank’s failure, did they inflate the bank’s stock price?

## Potential Plaintiff Claims (3 of 5)

- Additional potentially defective disclosures
  - Becker's affirmation of positive earnings guidance in mid-February
  - Any positive statement after learning of Moody's potential downgrade
  - Any positive statement during the months preceding the failure given the Fed and Blackrock warnings
  - Calls for confidence preceding the bank's collapse
- Will evidence emerge of inappropriate banking practices attributable to the interlocking nature of many client relationships? SVB did business with founders, their companies, VCs as individuals, and their VC funds. Were there "sweetheart deals"? *Quid pro quo* deals? How, if at all, would these deals have harmed the bank?
- Does Becker's position on the SF Fed board give rise to potential claims?

## Other Potential Claims (4 of 5)

- Will evidence emerge that some employees expressly warned management of dangers presented by SVB's capital structure and that senior executives ignored or minimized these warnings?
- Would these be duplicative of Fed and other warnings?
- Is that breach of duty or is it a legitimate difference of opinion?
- Is this a Delaware law "red flags" analysis?
- Did bank insiders tip some depositors about the bank run? Are there claims against the recipients of this information, if they preferentially withdrew funds and urged others to withdraw?
- Did the auditors fail adequately to warn of the risks presented by the capital structure, volume of uninsured deposits, and other financial factors?
- Derivative tag-along claims, and claims of fiduciary breach.

## Potential Plaintiff Claims (5 of 5)

- Insider trading against SVB's CEO, Becker.
  - Jan. 26: 10b5-1 plan in place. What did Becker know and when did he know it? Did he then possess material non-public information?
  - This inquiry mirrors the more general claims of deficient disclosure.
  - Feb. 27: Becker sells \$3.6 million of SVB shares pursuant to the plan.
  - Mar. 8: Bank announces \$1.8 billion loss on sale of \$21 billion in securities, and plans to raise \$2.25 billion through stock sales.
  - Mar. 9: Bank run as customers withdraw \$42 billion.
  - Mar. 10: Bank is shut down.

## Potential FDIC Claims

- The FDIC can be an aggressive litigator under FIRREA, which establishes gross negligence as a nationwide liability standard. State law otherwise controls.
- As of February 2014, Cornerstone Research reported that the FDIC had filed 84 lawsuits against 639 former officers and directors of banks that failed during the financial crisis.
  - See Galley, et al., “Characteristics of FDIC Lawsuits Against Directors and Officers of Failed Financial Institutions”, *Harvard Law School Forum on Corporate Governance*, Feb. 2014.
- All 40 lawsuits filed in 2013 alleged gross negligence, 35 alleged fiduciary duty breaches, and 32 alleged negligence. *Id.*
- “The most common claims brought by the FDIC ... allege... failure to ...heed warnings from regulators or advisors.”
  - Bank Directors Beware: Post-Crisis Bank Director Liability, 19 N. Carolina Banking Institute 31, 33 (2015).
- Can we expect the same claims against SVB insiders?
- Is FDIC exposure the greatest risk to SVB's officers and directors?

## Who Are the Auditors?

<u>Bank</u>	<u>Auditor</u>
Silicon Valley Bank	KPMG
Signature Bank	KPMG
First Republic Bank	KPMG
Regions Financial	Ernst & Young
Zions Bancorporation	Ernst & Young
PacWest Bancorporation	KPMG

## A Potential Goldman Sachs Defense

- The failed, publicly announced capital raise proximately caused the bank run.
- Maturity mismatches, VC concentrations, and deposits exceeding \$250,000 were accurately disclosed for months, and could not have proximately caused the collapse.
- Goldman did not anticipate that the capital raise announcement would cause a run.
- It would have been irrational for Goldman to recommend the capital raise if it expected a run that would kill the client and harm Goldman's own interests.
- Goldman has extensive expertise and SVB reasonably relied on that expertise.
- “While few could have predicted the market's violent reaction to the SVB disclosures, Goldman's plan for the bank had a fatal flaw. It underestimated the danger that a deluge of bad news could spark a crisis of confidence, a development that can quickly fell a bank.”
  - Andriatis, et al., How Goldman's Plan to Shore UP Silicon Valley Bank Crumbled, WSJ, March 15, 2023.

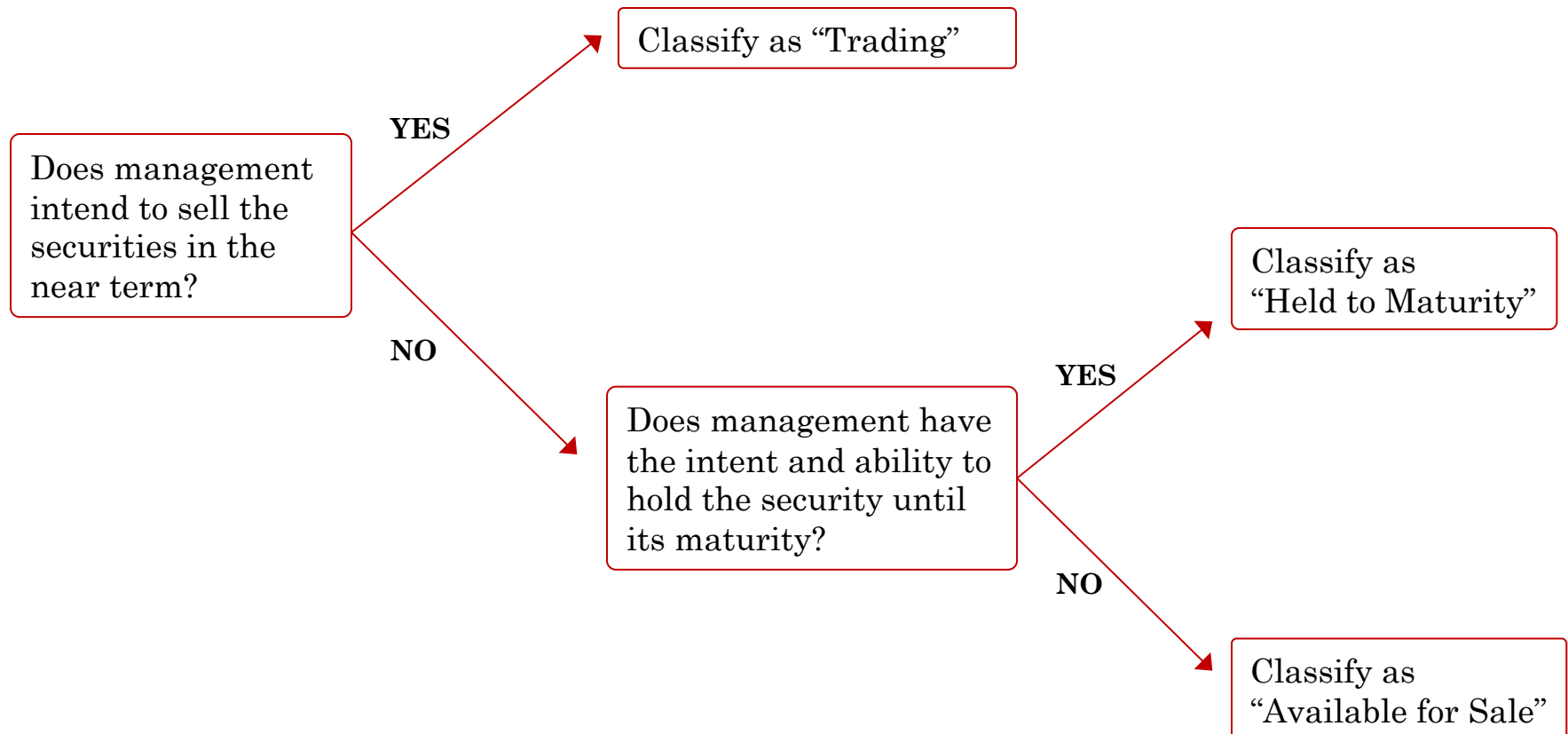


## A Potential Goldman Sachs Defense, Cont'd

- From this perspective, the run was an unforeseen consequence of the capital raise, and neither SVB nor Goldman can or should be held liable for an unforeseen event.
- There is no scienter, recklessness, or negligence, much less gross negligence.
- This was an honest, but large and unprecedented mistake.
- To be sure, in hindsight, the capital raises could have been done differently, but the test is not one of hindsight.
- Support in NYT, WSJ, and FT Reports.

## Big Picture – Debt Securities

- Debt securities are classified based on management's intent.



## Big Picture – Debt Securities, Cont'd

- Unrealized gains (or losses) are treated differently depending on the classification of the security.
- SVB held both AFS and HTM debt securities. The AFS securities are recorded at fair value on the balance sheet, but the HTM securities are recorded at amortized cost.

	Balance Sheet Valuation	Unrealized Gains or Losses
<b>Held to Maturity (HTM)</b>	Amortized Cost	Not recognized*
<b>Available for Sale (AFS)</b>	Fair Value	Recognized in other comprehensive income*

\*HTM and AFS securities are subject to impairment testing.

## Potential Full-Disclosure Defenses

- On December 31, 2022, the AFS securities were ~12% of SVB's total assets, and the HTM securities were ~43%.

(Dollars in millions, except par value and share data)	December 31,	
	2022	2021
<b>Assets</b>		
Cash and cash equivalents	\$ 13,803	\$ 14,586
Available-for-sale securities, at fair value (cost of \$28,602 and \$27,370, respectively, including \$530 and \$61 pledged as collateral, respectively)	26,069	27,221
Held-to-maturity securities, at amortized cost and net of allowance for credit losses of \$6 and \$7 (fair value of \$76,169 and \$97,227, respectively)	91,321	98,195
Non-marketable and other equity securities	2,664	2,543

- As shown on SVB's balance sheet (p. 95), the fair value of HTM securities declined from \$97.2B to \$76.2B in 2022.
- In accordance with accounting standards, however, these HTM securities were carried at the amortized cost of \$91.3B on the balance sheet.

# Potential Full-Disclosure Defenses

## Selected Quarterly Financial Statement Data SVB Financial Group 2021 – 2022

	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	Q4 2022
Held-to-Maturity Securities (Book Value)	\$41,165	\$59,992	\$82,365	\$98,195	\$98,707	\$95,814	\$93,286	\$91,321
Held-to-Maturity Securities (Fair Value)	\$41,187	\$60,107	\$81,995	\$97,227	\$91,667	\$84,579	\$77,370	\$76,169
<i>Difference</i>	\$22	\$115	(\$370)	(\$968)	(\$7,040)	(\$11,235)	(\$15,916)	(\$15,152)
Total Equity	\$10,121	\$11,967	\$14,669	\$16,609	\$16,360	\$16,276	\$15,810	\$16,295

Source: SVB Financial Group 10-Qs and 10-Ks.

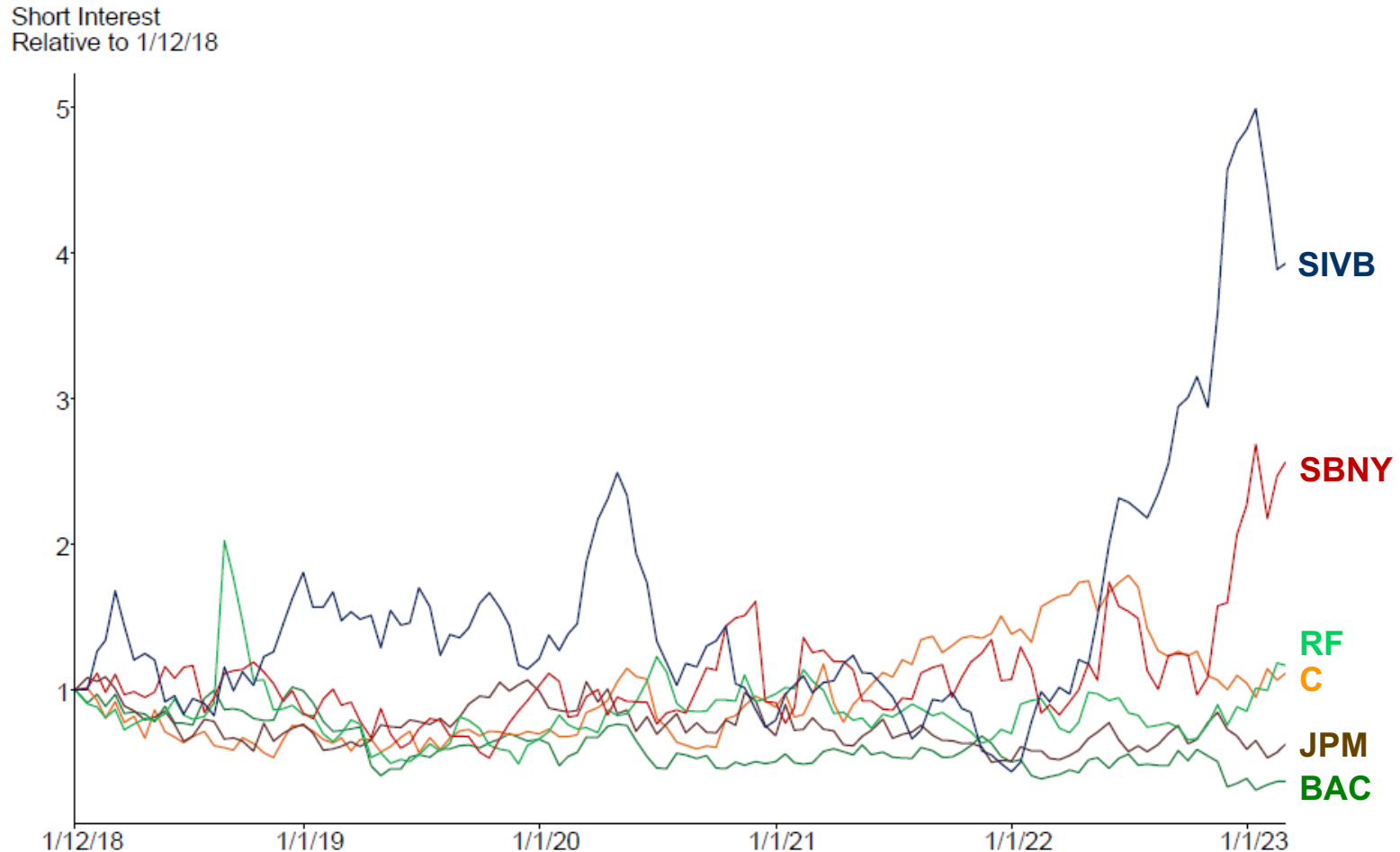
Note: Dollar values are in millions.

## Potential Full-Disclosure Defense, Cont'd

- More generally, SVB disclosed the issues that have been referenced as “red flags” thus far in media coverage.
- As cited by S&P Global, SVB disclosed in its call report that 93.8% of its deposits were uninsured—the highest of any bank with at least \$50B in assets.
- SVB disclosed its portfolio duration in its 10-K, noting that the weighted-average duration of its HTM securities was 6.2 years.
- SVB disclosed in its 10-K that it unwound >\$10B of interest rate swaps on its AFS portfolio in 2022, and that it lacked interest rate swaps on its HTM securities.

## Silicon Valley Bank and Competitors Short Interest Over Time

January 12, 2018 – February 28, 2023



## Potential Non-Negligence Defenses

- The regulators had full knowledge of SVB's portfolios and exposures but did not force changes, although they aggressively noted deficiencies. This reflects a non-actionable difference of opinion with the Fed that does not support claims of fraud or mismanagement.
  - “The Fed Was Too Late on SVB Even Though it Saw Problem After Problem,” Bloomberg, 3/15/23.
- Many other banks also have mark-to-market losses resulting from interest rate increases. Unrealized losses across U.S. financial institutions are about \$620 billion as of year-end 2022 according to the FDIC.
  - “Dozens of Banks May Have Risks Similar to [SBV], Economists Find.” WSJ, 3/17/23.
- The Federal Reserve has about \$1.1 trillion in mark-to-market losses in securities held on its own balance sheet.
  - Board of Governors of the Federal Reserve System, Combined Quarterly Financial Report for period ending September 30, 2022.
- SVB passed all capital and liquidity ratios and tests, and received a clean audit opinion.



## The Potential Twitter Defense

- “Customers withdrew \$42 billion ... on Thursday. That's \$4.2 billion an hour, or more than \$1 million per second for ten hours straight.”
  - Felix Salmon, *The Largest Bank Run in History*. Axios, 3/11/23.
- “To put that in context, the previous largest bank run in modern U.S. history took place at Washington Mutual bank in 2008, and totaled \$16.7 billion over ...10 days. That's a mere trickle in comparison to ... SVB.” *Id.*
- “No bank can withstand that kind of outflow in a single day — especially when a similar-sized outflow was all but certain the following day.” *Id.*
- Leading VCs publicly urged depositors to flee, thereby exacerbating the run.
- This was the first bank run broadcast through social media, and was more than traditional capital flight. It was also social media fright.
  - Ezra Klein, “Can We Slow This All Down Please?” NYT, 3/18/23.
- Was this foreseeable?

## The Potential Insider Trading Defense

- Becker had no material non-public information as of Jan. 26, 2023, when the 10b5-1 plan was adopted.
- Even if Becker anticipated the possibility that a capital raise might occur in the future, the probability was immaterial as of January 26.
- The proximate cause of the failure was the capital raise announcement, and Becker could not possibly have had that information as of January 26.
- Even if Becker possessed material non-public information as of the date the plan was adopted, its value was far less than that reflected by the bank's total collapse.

## Selected Depositor Concentrations at SVB

Company Name	Deposits (Estimate)	Percent of Cash/Equivalents
Roku	\$487,000,000	26%
iRhythm Technologies	\$54,500,000	26%
Oncorus	\$10,000,000	23%
Bill Holdings	\$300,000,000	12%
Sangamo Therapeutics	\$34,400,000	11%
Ambarella	\$17,000,000	8%
Rocket Lab USA	\$38,000,000	8%
Eiger BioPharmaceuticals	\$8,300,000	7%
Ginkgo Bioworks Holdings	\$74,000,000	6%
Roblox	\$150,000,000	5%
LendingClub	\$21,000,000	"Not material"

Source: WSJ

## Lessons from Treasury Practices

- How should large depositors manage their cash?
- Should large deposits be held only at TBTF banks?
- Which banks are TBTF post SVB?
- Should larger sums be moved to bank deposit substitutes, such as money market funds, treasury bills, or other instruments?
- What are the macro implications of funds migrating altogether from the traditional banking system, or further concentrating in TBTF banks?

## A New Regulatory Paradigm?

- Are all depositors now fully protected, even above \$250,000, if the Fed determines that a failure creates systemic risk, with a loose definition of ‘systemic risk’?
- Depositors at smaller banks would still be at risk under this regime.
- Stock and bond holders remain at risk and will not be bailed out.
- Private sector discipline thus relies entirely on stockholders and bondholders, but not at all on depositors, except at smaller banks.
  - But, as a practical matter, how much discipline do depositors generate, or do they primarily follow higher rates, which suggests that they are weak disciplinarians at best?
- Implications for the banking sector.
- There are no good solutions here. Is this the least bad solution?

## The Bank Term Funding Program

- “The BTFP offers loans of up to one year to... eligible depository institutions pledging any collateral eligible for [Fed purchases] in open market operations...these assets will be valued at par...[thereby] eliminating an institution’s need to quickly sell those securities in times of stress.”
  - Board of Governors of the Federal Reserve, Policy Tools, March 12, 2023.
- Borrowers pay the one-year overnight index swap rate plus 10 basis points, and margin is 100% of face value.
- Thus, a bank can now borrow \$100 million from the Fed by pledging securities worth only \$50 million on a MTM basis.
- Is this the Fed’s equivalent of “pretend and extend”? – a practice frequently criticized when adopted by real estate lenders and others.
- Irony: would this provision, which was adopted because of SVB’s collapse, have prevented SVB’s collapse?

## Deregulation and SVB's Collapse

- The 2018 Dodd Frank amendments increased the enhanced supervision threshold from \$50 billion to \$250 billion in assets, but also authorized the Fed to apply any prudential standard to any bank holding company (BHC) with assets exceeding \$100 billion.
- Thus, BHC's with at least \$100 billion, not \$250 billion, remained subject to enhanced supervision at the Fed's discretion. That includes SVB.
- The bill also authorized the Fed to “tailor or differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate.”
  - Public Law 115–174, “Economic Growth, Regulatory Relief, and Consumer Protection Act,” title IV, §401(b), May 24, 2018, 132 Stat. 1357.
- The amendments were adopted at the urging of banks with assets below \$250 billion who viewed compliance burdens, such as certain forms of stress testing, as inefficient.

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## Did Deregulation Cause SVB's Collapse?

- Senator Elizabeth Warren claims the rollback contributed to SVB's demise and wants legislation to reverse the rollback.
- Former Representative Barney Frank, co-author of Dodd-Frank, lobbied for the 2018 amendment and argues that SVB's collapse was unrelated to the amendments.
  - Frank was on the board of the failed Signature Bank and earned more than \$1 million from his board service.
- But if the Fed retained discretion to apply any prudential standard to SVB because its assets exceeded \$100 billion, isn't it the Fed's failure to apply prudential standards rather than a feature of the 2018 amendments?
- Were the regulators asleep at the switch?



## Regulators Asleep at the Switch?

- If regulators had all power necessary to prevent SVB's collapse, but failed timely to exercise those powers, is SVB's failure then ultimately that of the regulators?
- In announcing the resolution, "some Administration officials wanted to include that lapses in bank regulation and supervision had contributed to problems that helped fell the bank," but Powell pushed to exclude that text.
  - Fed Blocked Mention of Regulatory Flaws in Silicon Valley Bank Rescue, NYT, 3/16/23.
- "The Fed's 2022 stress tests didn't include interest rate risks. It too was fighting the last war." Klein, *supra*.
- The Fed is now investigating its own management of SVB's collapse.