In the Boardroom with Resnick and Fuller Episode 5

PLUS Staff: Welcome to this PLUS Podcast, “In the Boardroom with Resnick and Fuller.” As a reminder, the information and opinions expressed by our speakers today are their own and do not necessarily represent the views of their employers, or of PLUS. The contents of these materials may not be relied upon as legal advice.

In today's episode, Stephanie and John discuss the broad topic of banks and banking and how corporate boards and officers should think about their banking options in light of the recent collapse of Silicon Valley Bank, and fears of the potential for similar collapses. They are joined by Chris Pippett, a Fox Rothschild partner who chairs the firm's Financial Services Industry Practice group, and frequently advises banks and other financial institutions on corporate governance issues.

This wide-ranging discussion will touch on best practices for companies and boards, including knowing your bank and its position, diversifying banking relationships, the components of conducting due diligence, and how to think about risk management as it applies to a company's banking choices.

Stephanie Resnick is a partner at Fox Rothschild, a national law firm, and is co-chair of the firm's Directors’ and Officers’ Liability and Corporate Governance Practice Group.

For 14 years, Stephanie has been ranked by Chambers USA as a leading litigator in Pennsylvania. She's known for taking the lead in high stakes bet-the-company litigation and defending corporate boards and officers in complex and protracted litigation. Stephanie is a former managing partner of Fox's Philadelphia office and a past chair of its nationwide Litigation Department.

John Cornell Fuller is also a partner at Fox Rothschild and is the other co-chair of the firm's Directors’ and Officers’ Liability and Corporate Governance Practice Group. John has extensive experience defending directors and officers of public and private corporations in claims stemming from the discharge of their duties and management decisions.

Since 2015, Stephanie and John have been co-authoring articles on topics of interest to corporate boards and directors for a variety of publications, including

Corporate Compliance Insights, *The Legal Intelligencer*, and the *Wiley Board Leadership Journal*.

Christopher Pippett is also a partner at Fox Rothschild and is chair of its Financial Services Industry Practice. Chris advises financial institutions, including local and regional banks, credit unions and mortgage lenders on regulatory lending and workout issues. He frequently guides financial institutions through corporate governance issues.

I'll now turn it over to John to get us started.

John Fuller: Over the past few months there have been countless headlines about the collapse of Silicon Valley Bank and others and even more about what does the future hold and fears of similar collapses and the impact on companies.

As we've done in our prior podcasts, we want to take a look at this issue specifically through the lens of directors and officers and think about what individuals in those roles should be doing or can be doing to help guide their companies. And we couldn't think of a better person than our partner, Chris Pippett, to help talk through these issues.

Chris is head of our Financial Services Industry Practice and has spent his career guiding both financial institutions and companies through these issues. So welcome Chris. And I may just off the top ask you to take us through what happened with Silicon Valley Bank and how does it compare with 2008 just to set the table for us?

Chris Pippett: Thanks, John. Silicon Valley Bank obviously experienced troubles earlier this year and ended up being taken over by the FDIC. The problem that they faced at that point was actually liquidity, which means that they didn't have enough funds on hand to pay depositors when they came to withdraw their funds from the institution.

That's a little bit different than what we had in 2008 where we had a lot of banks and financial institutions that were heavily involved in the mortgage industry as well as mortgage-backed securities, so that impacted and presented more of a liquidity, not a liquidity problem like we have now, but an insolvency problem because they had bad loans.

So as a result of the loans going bad and the securities that they were basically wrapped into going bad, the banks, you know, their liabilities exceeded their assets. In that instance, there was an issue of, could the bank continue? Here, it was short term, but what happened was, because the word got out pretty quickly, because most of these, a lot of these companies, were interconnected. They had interconnected boards and other managers because Silicon Valley Bank's clientele was based in the venture capital backed startups in the tech and the health care industry.

So once word got out, it moved pretty quickly, and as a result in one particular day, depositors were able to withdraw over a third of the bank's deposits. And that's a serious problem. That's a lot different than a situation where you've got a regional or community or even a large bank that's more retail-based, because customers, it would take a while for a number of customers to withdraw that amount of deposits from the bank. So, in this instance, it happened quickly and there were a number of things that led up to it. There have been articles written about the bond sales and the different things that led to that shortage and led to the initial panic.

But so that puts it in perspective as opposed to, or context related to what happened in 2008, which is why I don't have a glass globe. But I don't really think that it's something that's widespread, although a lot of institutions are struggling with liquidity issues, largely the result of things that could never have been anticipated: the pandemic, spending following the end of the pandemic, and then inflation that kind of followed the spending. So, it was a set of circumstances that you really would've had to have that crystal ball in order to figure that out and figured that was coming.

Stephanie Resnick: Chris, as someone who is intimately involved with the banking industry, what would be your takeaway for officers and directors on the issue or the issues of liquidity and other similar issues?

Chris Pippett: The problem from the depositor side is it is very hard to measure because if you think about it, whether you're talking about 2008 or more recent problems that some of the banks that, you know, have had their struggles. You've got people that are in the industry that are smart people, that are talented, people that are managing from the inside, and they're obviously having trouble.

So, trying to do that from the outside is equally hard for a number of reasons. Number one: You don't have access to the same information that the executive teams and boards of those institutions might have. Some of that is available publicly because they all file quarterly reports, but by then, you know, you're talking about deeded information.

So, you know, it's not real-time reporting, so you're not seeing what it is. And the fact of the matter is that most banks, just by their business model, don't have a lot of funds on hand because their primary source of funding is deposits. And then they take those deposits and they lend it out.

So, on any given day at any bank in the United States, if they're doing what they're supposed to be doing, all those deposits are going out the door in loans and some in investments. But the majority in loans because that's how they increase their earnings. So, watching that on a regular basis, it would be difficult. Things that you could do, which we now have a little bit of the benefit of hindsight is, look at is this bank focused on a particular market or industry or geographic area? Could that present a problem?

The other biggest problem that I think a lot of depositors at Silicon Valley Bank had was they basically had all their money there. There were customers that had anywhere between $10 and $10 millions of dollars and up. And when that happens, and the bank gets taken over by the regulators and you suddenly realize that you only have access to $250,000, that can be a problem. Especially if you've got a $750,000 payroll to make the following week, which, a lot of depositors were faced with that issue, which I think is why the Fed stepped in to ease everybody's concerns in that regard.

John Fuller: Chris, you brought up the issue of the sort of diversifying funds to avoid some of these. As we said, we're always thinking about this sort of as difficult as it is for the board, directors and officers to try to find a way. So, I think diversifying was a thing a lot of people thought about in the aftermath of this.

Can you talk to us a little bit about … you mentioned looking at perhaps the industries or geographies of banks … how would you set out to think about where you should diversify if you realize that you have a lot of deposits on at one institution?

Chris Pippett: Yes. I think the one thing that boards should be asking our executive teams is the first, the obvious question: where do we keep our money?

And how much is there? And, that's what, that's the analysis that unfortunately too late, a lot of clients or a lot of businesses were going through when Silicon Valley failed. So, if you're a board member, you should be asking your executive team, where is our money? And does it make sense to diversify it?

And of course, the next question is: how do you do that? Because, depending on the size of your business and the sophistication or, resources that you have in terms of a finance team, having funds in 30 different banks can be a management challenge because, when you've got to make payroll or acquisitions or whatever, you don't want to be cobbling together funds in order to do that.

Now, there have been for some time and now they're, getting a lot more attention, networks that will do that for you. And that's something that I think a lot of boards ought to be asking: where the organization that they're charged with managing has a significant amount of funds in any particular institution. And, it's what, probably the one that is most popular or the one that everybody would know if they've looked at agreements in recent times or in the past is what's called the IntraFi Network.

And what that does is that'll take, if you've got $20 million on deposit at your institution and they offer that as a service, it'll sweep the money out, and spread it across however many institutions it takes in order to maintain FDIC insurance. And then as you need it, you'll sweep it back. It'll sweep it back. And there are some large New York banks that have the resources in order to make that happen. It operates much like a sweep account would. So that way on any given day, you've diversified your deposits to a number of banks, and if the bank that you're dealing with has a problem, then you'll still be able to get at those funds, because the way that it works is they're maintained in custodial accounts which are protected individually by FDIC insurance.

So that's probably what's becoming the most popular and the easiest to manage in terms of options for doing that.

John Fuller: Great. Let's say, as you referenced, maybe your accounts aren't so big or, moving around may have practical issues. If you're sitting looking at bank options or maybe, it's just a handful, you might think about diversifying, just cost a couple things.

You mentioned the challenges of lags and information and incomplete information. How do you feel comfortable, again at that board level, that you've done the due diligence that you're hoping to do?

Chris Pippett: I think primarily, especially depending on the level of funds that we're talking about, it does not hurt to ask your institution, “Hey, what's going on?”

And you can reference what's been happening in the financial institution industry and say, “Why are you any safer than they were? And explain that to us.” And get some answers. And of course, the key, I always tell boards, document that you did it because if you don't document it, it didn't happen.

So, you know when boards and executive teams are going through their due diligence and parsing through what makes the most sense for our organization … because it's definitely not one size fits all … make sure that you've documented what you've done, that you've asked questions at the bank in terms of the bank's health, what is its market focus, is it limited to one particular area, which, and that's important because if it's limited to a particular area and that area suffers a financial setback that's unique to other areas, that could impact the bank itself. So, you want to look at that because overall a lot of banks, most banks, look at their concentration risk. They're required to.

You have to look at concentration in terms of industries, geography, and those types of things to make sure. That is their one thing that can impact them. Now, sometimes that concentration is unavoidable. If it's a small bank in a particular area, they can't go out and open branches all over the country because they don't have the resources.

But that's also a reason to think about, okay, maybe we use this bank because there are advantages. It's not just big bank versus little bank. There are advantages to using small local banks because quite often you might get more in terms of attention, knowledge of what's going on in that particular area, and other benefits.

But maybe the answer is, we don't put all our money there and we look at diversifying. Another thing that I think directors and executive teams need to be aware of is, one of the reasons that a lot of these companies had so much money at Silicon Valley Bank is that quite frequently loan facilities require that. I've been doing commercial lending and workouts for the better part of 35 years. And I know the documents that I draft and documents that I've reviewed generally have that requirement: that the borrower will maintain its primary banking relationship with the lender. And I think that's one of the things that borrowers need to start asking: (A) what does that mean? Because I want to make sure that, if I only need $10 million on hand for operations or even $2 million on hand for operations, then I shouldn't have to put $20 million at that institution if I want to diversify it. So those are some things that you can look at in terms of how to best protect yourself.

John Fuller: That's fantastic. And I guess that sort of goes hand in hand too with understanding internally your company's needs and perhaps having to push back against bank requirements or desires. Do you have any thoughts on how boards can, or maybe some of the issues boards should be looking at when they're looking at risk management? When they're trying to figure out liquidity needs? Are there best practices in that area that come to mind?

Stephanie Resnick: And Chris, if I could tag onto that question, is there anything specific that board members should request from the officers to circulate to the board in that analysis? So, in other words, what documents would the board need in order to fulfill their analysis with respect to that particular point?

Chris Pippett: That's a good question, because I think boards need to know (A) how much cash do we generally have available at any given time? For some businesses, that may be a minimal amount. For others, it may be a large amount. The next is, okay, how much do we need on hand? What's our burn rate, in any given month or quarter or whatever it is, because you also don't want to be in a position, like I said before, where you're trying to cobble together money to either do transactions, make payroll, that sort of thing.

This came up a lot in when we were doing the Payroll Protection loans because there were companies that had significant amounts of cash on hand and it seemed like they wouldn't qualify. If you've got $10 million on hand and you've got a $1 million burn rate a month, that can go pretty quickly.

So those are the questions that you ought to be asking. I'd start on the front end. I call those front-end questions. What's our burn rate? How much cash do we need on hand? How much cash do we generally have on deposit at any given time? And, then the back end would be, okay, where is it? What kind of institution is it? How diverse is their customer base, as well as how they do their lending? And like I said, a lot of institutions especially focus on lending because they want to make sure they're not in any one sector, whether it's real estate or retail or anything like that.

And those are questions that if you're making significant deposit, say at an institution, you shouldn't hesitate to ask. And get that information from the institution. And that information should in turn be, like I said before, conveyed to the board. When they have those discussions, it ought to be part of a board packet and retained as that so that, in the aftermath, somebody's saying, hey, all our funds went down with that bank. What were you doing? You've got the documentation that shows you did the due diligence, you looked at the information, and you made the best decision that you could. And if you do that, you're going to be protected generally by the business judgment rule because you've taken the right steps in order to protect. You can't protect against everything.

Like I said, I think there were a lot of people at Silicon Valley Bank that didn't see that coming. And it wasn't like it was the Wild West and they didn't care. I just think they probably didn't see it coming. It'd been hindsight. Made some bad decisions that cost them. So, I think directors just need to ask those questions and get the information.

And then the executive teams, whether it's your CFO or whoever, needs to ask those questions at the bank. “Hey, we're going to deposit significant amount of funds with your institution. Tell us how you're different and how we would be protected.”

Stephanie Resnick: And one of the things that you've talked about in this response is mitigating the risk by really transparency of the board. I assume that it's your position that there should be complete transparency between the officers such as the CFO and the board, and all of this information that the CFO is obtaining or should obtain should be disseminated to the board for its review and assessment, even if it's just approving whatever the actions are of the CFO or requesting additional information with respect to its deposits and business operating funds or the like.

Is that right, Chris?

Chris Pippett: That's correct. I think it's pretty well established. In fact, there was some recent case law out of the Delaware Chancery Court that reiterated the concept and the rule that boards are entitled to whatever information they need in order to do the job that they have to do.

And this is obviously an important question that boards are asking now, because had it not worked out the way it did, there would've been some chaos. And people would've been pointing at boards and executive teams saying, “How come we didn't make payroll? How come we weren't able to close that transaction? How come we weren't able to pay taxes?” Because if you think about it, that was about the time, right? In that timeframe, things like that could have been disastrous, and those questions are still being asked. The one area that the Fed wasn't able to accommodate was with respect to, for instance, Silicon Valley had a branch in the Cayman Islands. Those depositors weren't protected, and there were some Hong Kong VC firms that still haven't … they're being treated as creditors of the institution and they're not first in line. Those are important questions and I'll raise that as another one.

If your organization is depositing funds outside of the United States, you may want to verify how that's protected, and you know why. You know whether or not there are other ways that you could do that because there were obviously some reasons for people in organizations to deposit their funds at SVB and the Caymans.

But it has not worked out well for them. And you want to make sure that … and this is the other side of it … if there's a very good reason to put those funds at that kind of risk, that information should go to the board and that should be documented that they got it and that was the decision that they made.

Stephanie Resnick: For instance, maybe a far more favorable loan arrangement or something like that.

Chris Pippett: Yeah. Or in the instance of depositing funds in an offshore branch, that there was some very good business reason for why that had to happen that way. And that would, at least document that it wasn't just, yeah, just put it there and, and then all of a sudden, they find out that it's not covered by FDIC insurance.

John Fuller: Chris, I thank you so much. We probably could talk about this all day. I know you could. But we really thank you for the time, and we'll find another reason to have you back.

Chris Pippett: Yeah. Appreciate it. My pleasure. All right. Thanks so much.

Stephanie Resnick: Chris, thanks so much. It's always nice to have someone who really knows what they're talking about when we do these podcasts, so thank you again.

Chris Pippett: Thank you.

PLUS Staff: Thank you, John, Stephanie and Chris for sharing your insights with PLUS, and thank you for listening to this PLUS Podcast.

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