

How To Deal With Letters Of Credit From Silicon Valley Or Signature Bank

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Commercial leases often require tenants to deliver letters of credit instead of cash security deposits. This practice reflects the belief that an L/C gives the owner better security than a cash deposit if the tenant goes bankrupt. Until very recently, many of those L/Cs came from Signature Bank or—especially for start-up or high-tech companies—Silicon Valley Bank.

When those banks failed, the L/Cs they had issued temporarily became worthless, because they are not backed by deposit insurance and simply represent contractual obligations of the issuer. The federal government solved that problem quickly. The FDIC declared that the “bridge banks”—the temporary banks that took over for the failed banks—would honor all contracts of the failed banks. That would include any outstanding L/Cs. Thus, any owner that had accepted a Signature Bank L/C became the holder of a Signature Bridge Bank L/C instead. The FDIC’s announcement also stated that “all obligations of the bridge are backed by the FDIC and the Deposit Insurance Fund.”

An owner might still worry that the L/C isn’t quite as reliable or as comforting as it was supposed to be. In that case, the owner will need to ask itself whether it can require the tenant to replace that L/C with a potentially “better” one. That will depend on the terms of the lease.

Some leases contain elaborate provisions that would probably entitle the owner to require the tenant to replace any L/C that was issued by a bank that failed, whether or not the successor bank or the FDIC stepped up to the L/C obligation. In those cases, the owner might simply demand that the tenant perform its obligations under the lease and deliver a new L/C. In a more typical case, however, the tenant probably has no obligation to do anything about the L/C. A tenant that cares about its relationship with the owner might very well arrange a replacement of the L/C anyway, if asked to do so.

Also, any Signature Bank or Silicon Valley Bank L/C will eventually expire and probably not be renewed, typically within a year. At that point, nearly every lease will require the tenant to deliver a replacement L/C. Of course, the owner will not want to wait around.

If the owner can require the tenant to replace a Signature Bank or Silicon Valley Bank L/C, or if the tenant wants to cooperate if asked to make such a replacement, what happens next and how long will it take? In most cases, it’s not all that difficult for a tenant to accommodate the owner’s request and deliver a new L/C from a bank that hasn’t failed.

Most L/Cs are issued by whatever bank provides the tenant's revolving credit line ("revolver"). The existence of a revolver means the tenant's bank has decided it is willing, for example, to lend the tenant up to \$10,000,000 at any one time. If the bank issues an L/C with a face amount of \$1,000,000, this implies the bank might need to advance \$1,000,000 at any moment, if the L/C were drawn upon. The bank would treat any such advance, if made, as one made under the revolver. As long as the L/C is outstanding, therefore, the bank will limit other borrowings under the revolver to \$9,000,000, to assure that the total loan balance can never exceed \$10,000,000.

If the tenant maintains several revolvers with various banks, the tenant can often obtain a replacement L/C rather quickly from another bank, assuming its revolver with that other bank has a low enough outstanding loan balance to accommodate issuance of an L/C. If the tenant had only one revolver, i.e., with only Signature Bank or Silicon Valley Bank, then the tenant won't be able to have a revolving lender issue a replacement L/C unless and until the tenant has set up a new revolver. That can take a while, especially in an environment of tightening credit standards and lower asset valuations.

In the meantime, the tenant might temporarily resort to a less sophisticated strategy to obtain a replacement L/C: the tenant can deposit cash with a new L/C issuer bank and then that new bank would issue an L/C backed by the cash deposit. Of course, that's not an optimal use of cash or one that every tenant can set up instantly.

Smaller companies that don't maintain any revolver in the first place often need to back their L/Cs with cash collateral from day one. If one of those companies deposited cash with Silicon Valley Bank or Signature Bank, that deposit should be treated the same as any other deposit. If it's covered by deposit insurance, which all deposits of the two failed banks now seem to be, the tenant should be able to get control of the cash rather quickly. The tenant can then use the cash as collateral to have another institution issue an L/C. That's quicker than setting up a new revolver, but it's still not instant.

If the tenant delivers a new L/C in place of the L/C from a failed bank, the tenant will typically ask the property owner to release the first L/C. This would also need to happen at the same time as the tenant moves cash between banks.

Any owner holding an L/C from Silicon Valley Bank or Signature Bank should make sure they know exactly where that L/C is stored. If no one can find it—which happens with some frequency—that can create a whole new set of problems. And today's focus on L/Cs also reminds every property owner that they should carefully track all L/Cs – not just their location but also their amount, expiry date, and issuer.

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