YPOG Briefing:
The Collapse of Silicon Valley Bank: Impact on German Startups

Hamburg/Berlin, March 14, 2023 | Matthias Kresser, Dr. Carsten Lösing

What happened?

On March 10, 2023, Silicon Valley Bank (SVB) in the U.S. and its subsidiary in the U.K. (SVB UK) were placed under the supervision of government regulators to stop a bank run unprecedented in this suddenness and speed. Since then, payouts of billions of euros in assets were not possible and were suddenly at stake.

The intervention of the supervisory authorities was preceded by a massive collapse in SVB's share price on the day before. The immediate trigger for this was the publication of planned recapitalization measures by SVB to cover the price collapse of long-term U.S. government bonds in which SVB had extensively invested client funds. This clearly caused many of those affected to worry that their deposits might no longer be fully covered. Since then, the media have been reporting hourly on all channels. The flood of information and opinions in the networks and social media has been endless.

Over the weekend, authorities in the U.S. and the U.K. responded to reassure SVB clients, to halt a further domino effect and stabilize the banking and financial system. In both countries, clients are soon likely to be able to again fully access their deposits in excess of the minimum deposit protection of USD 250,000 (US) and GBP 85,000 (UK), defying initial fears to the contrary.

In the UK, a buyer for SVB UK has already been found in the form of HSBC. A solution for SVB's main business based in the USA (SVB USA) has yet to be found and so, immediately after the weekend, the German Federal Financial Supervisory Authority (BaFin) closed the German branch of SVB USA to customer traffic (moratorium) until further developments for SVB USA's business are clarified.

Fears that the collapse of SVB could result in an immediate mass death of much of the tech industry in Silicon Valley and beyond due to its importance to the tech industry appear to be off the table for now, despite ongoing speculation about the longer-term impact on the financial world and the startup ecosystem.

What are the implications of the collapse for German startups?

In the following, we answer the most important questions for the German ecosystem at present.

Which German startups are directly affected by the collapse of SVB?

Startups in Germany that have taken out loans with SVB will be particularly affected by the collapse of SVB. They should now keep a very close eye on their liquidity situation (details below).

SVB has not been allowed to accept deposits in Germany due to lacking a full banking license. German startups have mainly had accounts with SVB UK to avoid negative interest rates in Germany or to conduct foreign business in the US or the UK.

What do I need to know if I have a bank account with SVB?

According to the supervisory authorities credit balances will be accessible in full in the short term. Despite these assurances, one should follow the developments and - at least for significant credit balances - engage a local lawyer to better assess the situation. We will be happy to put you in touch with somebody.

Significant deposits should generally be spread across various financial institutions (risk diversification). It should be noted that in addition to the statutory deposit protection of EUR 100,000 per depositor, private deposit protection schemes of German private banks operate with significantly higher (institution-specific) protection limits. Thus, in principle, a protection minimum of EUR 750,000 per depositor and institution applies to private depositors, with a maximum possible compensation amount of EUR 5 million for private depositors, foundations, and civil law companies. For all other depositors (companies in the real economy), a maximum limit of EUR 50 million applies in principle. The maximum limits are gradually being reduced to EUR 1 million for private customers and EUR 10 million for companies by 2030. Customers of savings banks and cooperative banks benefit from their independent protection systems. Specific information on the scope of protection can be obtained from the relevant bank.

If the payment transactions run via an account at SVB, an account should be opened with at least one other bank as soon as possible and the payment transactions (receipt of client funds, direct debits, linking with PayPal and other payment services, etc.) migrated there. Here, too, a local lawyer - with whom we are happy to put you in touch - can provide valuable support.

Can startups take advantage of loans that have not yet been disbursed?

Loan agreements for German startups with SVB are usually concluded with the German branch of SVB and therefore do not benefit from the acquisition of SVB UK by HSBC. Startups should not rely on being able to access loan amounts that have not yet been drawn down. At least for now loans are not being disbursed in either the US or Germany. Whether this will change (for which there are initial indications this will be so) will depend largely on the future of SVB USA and the German branch and this is currently uncertain.

In the UK, the situation is different due to the acquisition of SVB UK by HSBC: Here, it is still hoped that HSBC will continue existing loan relationships and enable disbursements to be made once more in the near future. However, this situation is also unclear at present and should be analyzed - with the help of English lawyers - particularly because of contractual peculiarities in SVB's English-law loan agreements.[1]

Do interest and principal currently need to be paid under existing loans?

In principle, payment obligations of startups to SVB are *not* suspended currently. Offsetting options and retention rights of borrowers are usually severely restricted in loan agreements and would have to be examined in each individual case based on the agreement. Therefore, startups cannot in good conscience be recommended to simply suspend payments at this time.[2] Whilst many may not fully appreciate this, under loan agreements payments not made by the due date generally lead immediately (or at best after a few days) to the lender's right to terminate the agreement. And a termination would, in many cases where startups do not have the liquidity necessary for full repayment at their free disposal, allow the SVB to draw on any collateral and immediately lead to the insolvency of the startup concerned (and thereby triggering an obligation to file for insolvency).

Is there a risk that SVB will cancel existing loans?

We consider it unlikely that existing loans will have to be terminated on short notice by SVB or the supervisory authorities (assuming a corresponding (special) right of termination) and subsequently will need to be repaid by the startups.

In the U.S. and Germany, regulators initially have no interest in terminating loan agreements because loans ultimately represent the bank's assets for which they are currently seeking buyers or investors. Cancellation of existing loans would in many cases result in insolvencies with uncertain prospects of satisfaction for SVB, i.e. cancellation would not maximize value from SVB's perspective and provisions would even have to be made for potential defaults. Warrants (option rights) or other rights, with which venture debt providers benefit from a rising valuation of startups, would generally lose their value. In the current situation this does not seem to be in the interest of regulators or potential buyers of SVB. However, the situation remains uncertain and should continue to be monitored.

In the U.K., HSBC is expected to initially resume the operations of SVB UK and, over time, consider whether to continue existing lending relationships or sell them (individually or bundled) to investors.

1 See in detail Withers' March 13, 2023 briefing, available at https://www.withersworldwide.com/en-gb/insight/read/uk-venture-debt-client-briefing-on-impact-of-svb-uk.

2 On the situation under English loan agreements, see also Withers' brief (link in footnote 1).

Are distressed debt investors now entering the scene and taking advantage of the situation to take over startups?

Funds and other investors whose strategy is to acquire non-performing loans to take over borrowers (so-called loan-to-own strategy) will only be interested in SVB's venture debt loans to German startups in exceptional cases. For one thing, pledging a startup's shares is unusual and the enforcement of pledged shares in Germany is associated with major unknowns. In such cases a loan-to-own strategy is almost technically impossible to implement. On the other hand, young startups usually depend heavily on the founding team and will rarely be successful without it. Before an acquisition, distressed debt investors would therefore need to negotiate the conditions for the founding team to remain. In addition, insolvencies are not a suitable fallback scenario for these investors because of the threat of high losses. This applies not only to so-called asset-light business models (SaaS and other software, etc.), but also in cases where the assets making up the collateral package have hardly any value in insolvency.

It remains to be seen which investors will develop an interest in a large number of small loans, which - measured against the loan volume - require a relatively high level of support. For many hedge funds or other alternative capital providers, this will hardly be feasible from a logistical perspective. It would be desirable for a major bank to also be found in the USA to enter the tech sector via the acquisition of SVB USA (and the German branch) and continue to strengthen the ecosystem with loans.

What do startups with thin liquidity cover need to consider?

In Germany strict insolvency filing obligations apply in the event of illiquidity and over-indebtedness. Failure to comply with these obligations can result in personal liability for the managing directors and even criminal consequences.

If illiquidity occurs, a petition for insolvency must be filed after three weeks at the latest. In most cases, however, the obligation to file for insolvency already exists before the onset of illiquidity, because companies are often already overindebted beforehand. In many cases there is simply a mathematical (balance-sheet) over-indebtedness (*rechnerische Überschuldung*) because assets for the purpose of determining over-indebtedness are generally recognized at break-up values. In the second step of the assessment, it is crucial to determine whether startups have a positive going-concern prognosis - in other words, a forecast of their liquidity situation to remain positive. Currently the period in which a startup must be financed with a predominant likelihood (*überwiegende Wahrscheinlichkeit*) has been temporarily reduced (from twelve) to four months and the period for filing for insolvency due to over-indebtedness has been extended (from six) to up to eight weeks.[3]

Before the collapse of SVB, startups could rely on being able to draw on contractually available loans as required. At least for now it is uncertain whether this source of liquidity is still predominantly likely to be available. Founders will not want to rely on this, also because of the personal liability risks. Ideally, therefore, the prognosis for a startup’s going concern should be based on other sources of liquidity. The details depend strongly on the individual circumstances in each case, which is why appropriate advice should be sought at an early stage if liquidity bottlenecks become apparent. This is necessary not only to create necessary reserves for payment obligations that expose management to possible personal penalties (e.g. certain taxes, employee contributions to social security) and to

[3] See our January 20, 2023 briefing, available at https://www.ypog.law/insights/insolvenzantragspflicht.

keep liability risks as low as possible. It may also make sense to take a look at the D&O insurance policy to check whether it also covers claims for compensation for payments made after the company has become technically insolvent (§ 15b InsO or § 64 GmbHG old version).

What alternative sources of liquidity should startups think about?

Immediately following the regulatory takeover of SVB, other providers of venture debt and other financing for growth companies have offered the prospect of providing short-term solutions to prevent a collapse of the startup ecosystem. The focus of these providers at this time is likely to shift from a very short-term solution for secured balances to refinancing options for existing SVB loans. We know many of these providers personally and will be happy to put you in touch if needed.

In order to create as many options as possible, it is advised to compile or update the information and documents essential for due diligence (KPIs, development, burn rate, business and liquidity planning, etc.). We expect that many of these providers (and possibly also existing investors) will make refinancing dependent on at least a limited due diligence exercise.

In the case of very short-term liquidity requirements, other sources of liquidity must be used. In addition to loans or extensions of payment terms from customers and suppliers (hardware), revenue-based financing and classic factoring can also be considered, particularly for startups with recurring revenues. In addition, founders will in many cases have to approach their existing investors and discuss bridging loans, convertible loans, letters of comfort or other financing commitments simply because of the limited time available.

Does it make sense to refinance existing SVB loans at this time?

Early refinancing of existing SVB loans or at least the exploration of corresponding offers might be appropriate as long as the future of SVB USA and the German branch remains uncertain. Early repayment is usually associated with fees (so-called prepayment fees). However, for many SVB loans, these fees are in the low single-digit percentage range, depending on the remaining contractual term of the loan. This can be clarified quickly with a quick review of the agreement.

If startups use *letters* of *credit to* finance their business operations, they should be replaced as soon as possible.

Conclusion

For affected startups, the initial shock is now being followed by a phase of uncertainty that needs to be mitigated. Short- and medium-term liquidity planning based on current sensitivities is now essential to have alternative sources of liquidity available at the right time. It is easier to say this in a crisis than it is to put it into practice: cash is king.

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