ALERT MEMORANDUM

# Corporates Face Novel Risks from Debt Ceiling Impasse—Even if No Default Occurs

*May 25, 2023*

As the threat of an unprecedented default in U.S. government debt plays out over the coming months, the United States is in uncharted territory. And so are directors and management teams at corporates, whether public or private. While there have been a number of actual and threatened "government shutdowns" in recent years, and government agencies and executives have experience navigating them, a market perception of a credible default risk on U.S. debt (even short of an actual default) would be a new scenario for which no one has a playbook.

But parts of the financial markets and the rating agencies are beginning to notice the lack of legislative progress[1] and the broader financial markets may react in the coming weeks with implications for corporate capital raising, liquidity and risk management.

For companies that depend on functioning capital and loan markets for liquidity, it's time for planning—both for potential dislocations that may come if investors and lenders begin to perceive a credible risk of a default, and for the shocks that will come if a default, previously unthinkable, actually happens.

While this article offers directors and management teams some thoughts on actions they may wish to take, to be clear, it's our strong view that politicians on both sides of the aisle have a responsibility to the country to resolve the debt ceiling impasse promptly and before the country and the economy are harmed. We hope they will do so and make this article irrelevant.

---

[1] "Debt Ceiling Jitters Drive Up Cost of Insuring against US Default," Financial Times (April 13, 2023), available here; "US Credit Rating at Risk for Downgrade Amid Debt Ceiling 'Brinkmanship,'" Financial Times (May 25, 2023), available here; "Dow Drops Nearly 300 as Wall Street Worries over Debt Ceiling Negotiations." (May 24, 2023), available here.

© Cleary Gottlieb Steen & Hamilton LLP, 2023. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

## We've Seen Shutdowns Before—but not Debt Defaults

In recent years, the U.S. government has shut down a number of times because Congress didn't authorize appropriations of cash. When this happens, the U.S. government has an *authorization problem,* in which cash is available to be spent, but Congress has failed to authorize the spending. This is an *appropriations lapse scenario*.

In an appropriations lapse, the government "shuts down" but continues to pay its debt, and has a playbook for conducting itself day-to-day. In fact, there is a statute, the Antideficiency Act, 31 U.S.C. § 1341, which specifies that agency heads and their employees cannot make or authorize expenditures in excess of appropriations but allows some essential activities to continue. Moreover, several government agencies, including the Securities and Exchange Commission,[2] have operations plans for an appropriations lapse and resulting government shutdown. These plans lay out in great detail which of the agencies' activities will continue and which will not (for example, in the SEC's plan, EDGAR support remains open, but approvals of registration statements and staff training stop).

By contrast, if Congress doesn't raise the "debt ceiling," as the legal cap on how much the federal government can borrow is known, the U.S. government will have a *liquidity problem*. This is a *default scenario*. In a default scenario, Congress has previously authorized spending (to pay employees, repair roads, pay interest on the government's debt and so on) but, the government can't borrow and doesn't have enough tax revenue to make those payments, and eventually the Treasury Department would be forced to default on its debt. In order to avoid that scenario, Congress needs to reach an agreement to raise the debt ceiling.

The United States is no stranger to debate over whether to increase its debt ceiling. The debate has been had in Congress dozens of times following the statutory imposition of the limit in 1917. It has now re-emerged after the federal government reached its $31.4 trillion debt ceiling on January 19, 2023. As part of this debate, on April 26, 2023, the House of Representatives narrowly passed a bill proposed by Speaker Kevin McCarthy to raise the debt ceiling for one year in exchange for a series of budget cuts. The bill is not expected to pass in the Democratic-led Senate, and President Biden, who has repeatedly proposed that Congress raise the debt ceiling without conditions and address budget negotiations separately, has threatened to veto it if it does.

If the bill fails, the House of Representatives will need to find an alternate path to raising the debt ceiling in the in order to avert a default, as Treasury Secretary Janet Yellen stated on May 1, 2023 that the Treasury Department estimates the U.S. government will exhaust its ability to continue satisfying its financial obligations in early June, and potentially as early as June 1.[3] The impacts of a default on the U.S. economy are highly uncertain, and Federal Reserve Chair Jerome Powell has said the Federal Reserve is unlikely to be able to protect the U.S. economy from resulting damage.[4]

While corporate borrowing/lending markets so far have not reacted strongly to the possibility of a debt default, at some point they may take it more seriously—and when that will be is difficult to predict.

Adding to the uncertainty, there is no formal guidance or blueprint for how the government will operate if the U.S. defaults on its debt obligations, particularly since past budget negotiations have always ended in the debt ceiling being raised or suspended. The most detail we could identify is a letter that the Treasury Department sent to then-Senator Orrin Hatch detailing some of the options it considered to address a potential default

[2] *See* here.
[3] *See* "Treasury Says U.S. Will Hit the Debt Limit 'As Early As June 1,' Sooner Than Expected," NBC News (May 1, 2023), available here.
[4] *See* "Fed's Powell: Don't Assume Fed Can Shield U.S. Economy From Debt Limit Default," Reuters (May 3, 2023), available here.

during the debt ceiling impasse of 2011. The letter indicated that Treasury had considered "asset sales; imposing across-the-board payment reductions; various ways of attempting to prioritize payments; and various ways of delaying payments."[5] The letter does not indicate how Treasury would have implemented those options, but it does note that Treasury officials "viewed the option of delaying payments as the least harmful among the options under review." And, while the Treasury Department has recently stated that it is not operationally feasible to prioritize payments[6] and thus continue payments on the national debt while holding back payments on other obligations, there is evidence from the 2011 impasse that such a plan might be practicable.[7]

## Debt Ceiling Impasse of 2011 - Data Points

The 2011 impasse over the debt ceiling was allowed to continue to a point where some market dislocations appeared prior to a legislative compromise being reached, reflecting concerns of various market participants. For example, in the final week of that episode[8]:

- Money market funds and other market participants began to hold onto significant amounts of liquidity, partly by reducing exposure to Treasury bills and short term repos and increasing deposits at financial institutions.
- Several major custodial banks experienced substantial deposit inflows, pressuring their leverage ratios, as investors favored holding cash balances.
- Treasury-only money funds saw outflows grow to 8% of assets for that week, a rate that could have accelerated if the impasse had continued.
- Short-term interest rates experienced upward pressure, including the Treasury bill, repo and commercial paper markets.
- Trading volumes in the Treasury repo and Treasury bill markets fell (but not the Treasury coupon securities market) and transaction costs rose.

## What Corporates Should Do

Given the uncertainty about whether or when the U.S. government could default and how and when markets will begin to react, we would suggest taking some steps now, both to address future market dislocations and an actual default.

**Steps to Address Nervous Markets Anticipating a Default**

- If markets begin to perceive a credible risk of a default, interest rates may spike; corporates with short-term funding needs may wish to access the market sooner than they otherwise would in order to pre-fund ahead of a potential spike.
  - Consider whether it is preferable to fund at fixed rates rather than floating rates (or hedging your floating rate loans) to help mitigate the risks associated with interest rate volatility.
  - For SOFR-based floating rate debt, we may see an increase in SOFR, because SOFR is calculated based on transactions in the repo market with U.S. treasuries as collateral.
- For corporates that access the U.S. public markets but that do not have a shelf registration statement in place or that may exhaust the capacity of their shelf registration statements in the months to come, consider placing a new shelf registration statement on

[5] *See* here.
[6] *See* "Here's Why Janet Yellen Doesn't Think Prioritizing Payments Would Avoid a Debt Ceiling Debacle," CNN (March 22, 2023), available here.
[7] *See* "Conference Call of the Federal Open Market Committee," transcript (August 1, 2011) at 11, available here [hereinafter FOMC].
[8] *See* FOMC, 8-10, here.

file. Given the potential uncertainty around whether, and the extent to which, government agencies will be operating, having an existing shelf registration in place will maximize the possibility of being able to issue debt even if the SEC is unable to declare registration statements effective.

- We recommend that corporates begin to discuss contingency plans for a U.S. government default with their boards of directors. Corporates may also need to consider whether to disclose these contingency plans and the nature of their board of directors' oversight of such plans in their periodic reporting.
- If a default occurs, the economy is more likely to experience a recession or a recession may occur sooner than it otherwise would have. Management teams may want to review their operational plans addressing recession risks to ensure that those plans (including the base case scenario) remain appropriate, particularly in light of a given company's industry and recession exposure.
- A spike in interest rates in anticipation of a default could exacerbate lingering concerns about the banking sector in the aftermath of Silicon Valley Bank's collapse, particularly the risks of uninsured deposits. While corporates can be expected to evaluate their exposures to banks as uninsured depositors, the FDIC's invocation of "systemic risk" to protect uninsured depositors in the failures of Silicon Valley Bank and Signature may result in more stable uninsured deposits, at least in the near term.
- Corporates should review their bilateral swap contracts to determine whether they include any requirement to deliver more or different margin collateral if the US is downgraded or treasury securities are downgraded or in default.

**Steps to Address an Actual Default**

- Consider establishing or expanding your options to borrow in non-dollar currencies through non-U.S. lenders. If a U.S. default occurs, it's difficult to predict the impact on global markets; however, the ability to borrow in non-dollar currencies may prove useful.
- Corporates holding investments in money market funds investing in short-term Treasury bills may face increased risks in the months to come, as the Treasury Department may stop paying those bills during a default. As a result, money market funds may be unable to provide cash upon redemption of those funds. Corporates may need to consider whether to move their investments into funds investing in longer-term Treasury bills, into direct investments in longer-term Treasury securities, or into instruments of other highly-rated obligors, such as foreign-denominated bonds, municipal bonds or corporate bonds.
- Review executive compensation plans and programs and begin to assess the impact a potential default and/or recession may have on those programs. A disruption to U.S. markets could negatively impact incentive-based compensation (e.g., performance targets may become unattainable and/or equity incentive awards may lose significant value), leading to executives becoming distracted and under incentivized to perform at a time where their focus on navigating external market pressures will be critical. Potential modifications to these programs will need to be assessed in light of other stakeholders and constituents, including institutional investors and proxy advisory firms.

…

CLEARY GOTTLIEB

## Authors

In light of the broad implications of a US default, this alert memorandum reflects input from a similarly broad number of expert co-authors, all of whom are available to answer questions.


### Capital Markets

**David Lopez**
+1 212 225 2632
dlopez@cgsh.com

**Adam Fleisher**
+1 212 225 2286
afleisher@cgsh.com

**Nikta Daijavad**
+1 212 225 2068
ndaijavad@cgsh.com

### Debt Finance and Loan Markets

**Meme Peponis**
+1 212 225 2822
mpeponis@cgsh.com

**Duane McLaughlin**
+1 212 225 2106
dmclaughlin@cgsh.com

**Amy Shapiro**
+1 212 225 2076
ashapiro@cgsh.com

### Derivatives and Swaps

**Michael Dayan**
+1 212 225 2382
mdayan@cgsh.com

**Deborah North**
+1 212 225 2039
dnorth@cgsh.com

**Clay Simmons**
+1 212 225 2183
csimmons@cgsh.com

### Governance

**Francesca Odell**
+1 212 225 2530
flodell@cgsh.com

**Helena Grannis**
+1 212 225 2376
hgrannis@cgsh.com

### Commercial Law

**Brandon Hammer**
+1 212 225 2635
bhammer@cgsh.com

### Financial Institutions and Bank Regulation

**Derek Bush**
+1 202 974 1526
dbush@cgsh.com

### Executive Compensation

**Michael Albano**
+1 212 225 2438
malbano@cgsh.com

**Audrey Casusol**
+1 212 225 2430
acasusol@cgsh.com

### Sovereign Debt

**Rich Cooper**
+1 212 225 2276
rcooper@cgsh.com

**Jim Ho**
+44 20 7614 2284
jho@cgsh.com