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Planning for the threat of a U.S. sovereign default

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The Treasury Department advised Congress last week that the government is expected to reach its debt limit on January 19. After that, Treasury will be required to take "extraordinary measures" to avoid default. Absent action to raise the statutory ceiling, Treasury expects to exhaust those measures by early June. Whether or not default happens, a growing threat may start to have consequences for companies that rely on functioning U.S. credit and capital markets.

Writing to Congress on January 13, Treasury Secretary Janet Yellen notified lawmakers that the U.S. debt level is projected to reach its statutory limit on January 19, after which "Treasury will need to start taking certain extraordinary measures to prevent the United States from defaulting on its obligations." Secretary Yellen indicated that such measures would likely stave off default until early June 2023.

Increasing the nation's debt limit is in the hands of Congress and the administration, but policy differences between the two branches may result in an impasse, raising the threat of a historic sovereign default by the United States.

Given the central role of U.S. Treasury securities in the pricing of risk assets and the unprecedented nature of a default by the U.S. government, market observers have speculated that a default could roil credit and capital markets in the United States and beyond with consequences to businesses and the broader economy that cannot be fully understood in advance, either in terms of severity or duration.

Whether or not a U.S. sovereign default eventually occurs, the apparent threat could begin to have adverse consequences for companies that, one way or another, depend on functioning U.S. credit and capital markets.

Although it may be impossible to predict the fallout, companies should consider contingency planning to mitigate any significant impact, including on the topics covered below.

Board risk oversight

Boards are charged with understanding and overseeing the company's management of key risks, and are uniquely positioned to support companies in crisis situations. In the context of the threat of a U.S. sovereign default, companies should consider whether to:

- Brief boards on management processes and systems to monitor and assess risks stemming from a potential default, and the development and implementation of contingency plans.
- Maintain frequent communication with the committee primarily responsible for the oversight of relevant risks, which in this case may be the audit, finance or risk committee.
  - Alternatively, when the board believes that the situation may be particularly significant and sensitive, there may

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be benefits to forming an ad hoc committee, comprised either of the CEO and committee chairs or a few directors with specialized expertise and the ability to devote the necessary time.

— Delegate to the responsible standing or ad hoc committee additional authority to review and approve corporate actions that may be needed on an immediate or emergency basis.

As always for any judgments that may be questioned in hindsight, special care should be taken to ensure that boards and committees are making informed judgments when exercising their duties, and establishing appropriate records.

Access to liquidity

Headwinds from the threat of a potential U.S. sovereign default could stress a company's access to liquidity. In addition, if a default or continuing political stalemate leads to a U.S. government shutdown, companies may face additional hurdles to accessing the U.S. public capital markets.

Accessing the capital markets

Companies may need to be nimble in order to take advantage of windows to access public and private capital markets.

— If a company does not have a shelf registration statement on file, it should consider putting one up now. This will allow flexibility to raise capital without delay when the need arises and a window is available.
  - If a company has a shelf up, how much remaining capacity does it have, and when does it expire? If there is limited remaining capacity or the shelf expires soon (shelf registration statements expire after three years), the company should consider filing a new shelf.
  - While a registration statement filed by a "well-known seasoned issuer" (WKSI) is automatically effective upon filing, a WKSI without a shelf should consider the risk that a government shutdown might interfere with the SEC's filing operations and plan accordingly.
  - A non-WKSI must have its registration statement declared effective by the SEC staff, which takes some lead time and may not be possible during a government shutdown.

— Many companies are now in the process of preparing their fourth quarter earnings release and annual 10-K filing, and are not in a position when they would typically consider accessing the capital markets. Nevertheless, companies may now have flexibility to take advantage of opportunities to raise debt or equity capital, even during a blackout period, as we discussed in this client update.

Drawing on a revolver

During the 2008 financial crisis, some companies proactively drew on their revolving credit facilities when, for example, opaque market conditions made it difficult to be confident they would not experience future problems satisfying drawdown conditions. Other companies considered doing the same in 2020 at the outset of the COVID-19 pandemic.

A company considering whether to draw on its revolver should consider factors such as:

— Is the company able to satisfy the conditions to borrowing?
  - For most companies, these require that all representations and warranties be true and that there be no default at the time of borrowing.
  - Revolving credit facilities often include a "no material adverse change" representation and, sometimes, a solvency representation, both of which will require fact-sensitive analysis that may be heavily impacted by

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external events.

- Is the borrowing permitted under the company's other debt instruments?
- What is the impact of the borrowing?
  - Could the borrowing trip any leverage or coverage test in the future?
  - Could the borrowing adversely affect pricing, or adversely affect thresholds at which the company can take certain actions, such as dividends, stock buybacks or investments?
  - What about any impact on the company's credit ratings?
- Remember that even if a company has already filed its revolving credit agreement, a drawdown can itself trigger an 8-K item 2.03 reporting requirement if the drawdown is "material."

Disclosure and other market communications

The potential impact of a U.S. sovereign default on a company's business, operations or prospects can quickly have implications for its required disclosure and market communications.

- ***Guidance and market expectations*.** Companies need to consider the impact of any potential default and resulting market disruptions on publicly announced guidance or outlook, as well as on market and securities analyst expectations.
  - If a company's guidance or market expectations may be significantly impacted by the default threat in a way that may not be obvious or understood from past disclosures, the company should consider whether and when to make this clear. While a company that is currently observing a quiet period may be able to avoid public comment until its earnings announcement, the risks and benefits of doing so should be weighed by senior management.
    - Companies whose guidance or market expectations may be significantly impacted by the changes in federal spending that could underpin any eventual deal might also undertake a similar analysis.
  - Some companies may choose to formally withdraw guidance in the face of widespread uncertainty, as occurred at the start of the COVID-19 pandemic.
  - EPS guidance and expectations may be impacted by a need to shift capital allocation away from stock buyback activity.
- ***Annual reports currently underway*.** Companies should review their 10-K and 20-F drafts and consider whether the threat of a U.S. sovereign default should be foreshadowed.
- ***Risk factors and forward-looking statement disclosure*.** Companies will need to take a fresh look at their risk factors and forward-looking statement disclosure to ensure they adequately address the threat of a U.S. sovereign default, particularly if a company has not engaged in this exercise since 2011 when the United States first lost its triple-A credit rating.
  - While the SEC does not expect companies to include generic risk factors about events that affect companies broadly, companies should consider any specific impact on their own activities that could require such disclosure.
- ***Trends and uncertainties*.** Companies will want to focus on the requirement to disclose in MD&A trends and uncertainties that are expected to have a material impact on future results of operations or capital resources:
  - How might the threat of a U.S. sovereign default impact the company's ability to refinance its debt or access needed liquidity?
  - How might the threat affect its customers and demand for its products and services?

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- How might it affect the company's value chain and ability to produce?
- Are its competitors better positioned to weather any macroeconomic uncertainty?

8-K reporting requirements

8-K reporting obligations that could be triggered by developments in the wake of a threatened U.S. sovereign default include:

- ***Change in guidance***. A guidance or outlook change may create an 8-K reporting obligation. If the quarter is still in progress, any Regulation FD-compliant manner of reporting is usually sufficient, although we expect most companies will use 8-K item 7.01 instead of relying only on a press release or other public announcement. (Note that if a guidance change relates to the just-completed quarter and is announced prior to the earnings release, this is subject to 8-K item 2.02.)
- ***Ratings downgrades and other triggering events***. 8-K item 2.04 reporting may be required if a ratings downgrade or other event results in the acceleration or increase of a debt obligation.
- ***Reductions-in-force***. Material charges resulting from a reduction in force (RIF) may trigger an 8-K item 2.05 report.
- ***Termination of a material agreement***. Termination of a material agreement under a force majeure or similar clause may trigger an 8-K item 1.02 reporting requirement.
- ***Material impairments***. A decision to take a material impairment charge triggers reporting under 8-K item 2.06.
- ***Failure to meet a continuing listing standard***. If a company receives a delisting notice, or notifies a stock exchange that it is not in compliance with a continuing listing standard, an 8-K item 3.01 report is triggered. For example, a NYSE-listed company faces delisting if the average closing price of its common stock is less than $1 over a consecutive 30 trading-day period.

Selective disclosure and insider trading

In an uncertain economic environment, the SEC may focus on possible instances of selective disclosure—especially when prior guidance may no longer be reliable or market expectations may be off.

- Communications with securities analysts and large investors, in particular those that involve guidance or analyst forecasts, always carry heightened risk and must be managed with care.
- Communications with suppliers and customers in their capacities as such should generally not be covered by Regulation FD. However, because these communications may well involve material nonpublic information (MNPI), it is a good idea to remind suppliers and customers that the communications are confidential and, if applicable, covered under confidentiality or non-disclosure agreements.
- Similarly, while communications with employees are generally not covered by Regulation FD, companies should take care not to include MNPI in employee communications unless the receiving employees understand that they may not trade before it is made public or is no longer relevant.

Opportunistic acquirers and activist interest

Many companies have already experienced a fall-off in equity value over the last 12 months, and knock-on impacts from a threatened U.S. sovereign default could accelerate these trends, increasing the risk of an opportunistic party entering the stock or the risk of attracting unwanted activist attention.

Companies that have not already done so should consider putting a "stock watch" in place to try to detect

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accumulations of stock—although it's not possible to know all potentially relevant positions, given that swaps and other derivative holdings may not be disclosed under existing 13D/G/F rules.

Takeover defenses

- Potential market dislocations may allow for rapid, undisclosed accumulations of positions at materially depressed prices. An opportunistic party may be able to achieve a position of substantial influence or control without paying a control premium to other stockholders.
- Companies should therefore review their defensive profiles.
  - A company that does not have a rights plan (poison pill) ready and "on the shelf"—drafted and fully reviewed by the board but not yet adopted—may consider doing so.
- A board may also want to consider whether it makes sense, in extreme conditions, to adopt a rights plan before an actual threat becomes apparent.
  - The board would want to consider the company's particular situation and the ways in which a plan may be customized to its circumstances, including as to term, trigger percentage and treatment of passive investors.
  - A board adopting a rights plan before the actual threat appears will also want to be prepared to communicate its rationale to key stockholders and proxy advisers.

Activist interest

- Companies should consider readying their activist response plans in expectation of depressed stock prices, including making sure their investment bank, communications, proxy and legal advisers are available for action.

Impact on pending transactions

The threat of a U.S. sovereign default may have implications for pending transactions, including acquisition agreements, financing arrangements and commitment letters.

- Companies should review terms under pending transaction documents that may be impacted by the threat.
  - "Material adverse event" and similar clauses may be impacted. For example, do these clauses have exclusions for changes in market or economic conditions that would include the effects of a threatened or actual U.S. sovereign default?
- Financing timetables may need reconsideration in view of market uncertainty.
- How are financing commitments impacted?

Stock buybacks and 10b5-1 plans

Stressed market conditions may provide some companies with attractive stock buyback opportunities (despite the new excise tax), although other companies will want to conserve cash.

New reporting rules for stock buybacks have been proposed by the SEC but have not yet been adopted, and new rules for 10b5-1 plans take effect on February 27.

Rising uncertainty could prompt a company to consider whether to cancel an existing buyback plan, or whether to

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permit (or direct) executive officers to cancel or suspend 10b5-1 plans.

- The recent changes to rule 10b5-1 require action in “good faith” from the time of plan adoption through plan expiration.
  - This raises the question of whether it is possible to terminate or suspend a plan early without forfeiting the affirmative defense to a charge of illegal insider trading under rule 10b-5 or Section 10(b) of the Securities Exchange Act of 1934.
  - While we think plan cancellation or suspension under appropriate circumstances should not affect the viability of the affirmative defense, companies should make sure that the circumstances are adequately considered and documented.

Executive and director compensation and other HR considerations

The threat of default on U.S. debt could cause companies to consider various measures to reduce personnel costs, including pay cuts, furloughs or layoffs.

- When implementing personnel cost-cutting measures, a number of companies may consider reducing executive pay as well as director retainers, as many companies did at the outset of the COVID-19 pandemic.
  - Consider also the associated Form 8-K requirements we discuss above resulting from a RIF.
- Companies that may be considering reducing either executive or director compensation should review the necessary approval and disclosure requirements, and requirements under applicable law.
- Companies should also consider the implications that any such reductions may have for existing contractual arrangements and compensation and benefit programs and the impact on related calculations such as stock ownership requirements and computations under the golden parachute rules.
  - Evaluating these direct and indirect impacts can facilitate action in a proactive and thoughtful manner both with respect to the structure and rollout of any pay reduction program, and the manner in which such reductions in pay are communicated.
- Companies that grant stock options may find them underwater, or further underwater, which may prompt a review of their ability to retain and incentivize key employees; companies may want to consider an option exchange program, an action that some companies took during the COVID-19 pandemic.
- Companies may also consider acknowledging in the CD&A the potential impact of a U.S. sovereign default on the company’s 2023 performance and reminding stockholders that this impact was not factored into 2022 compensation, but may be a factor in 2023 compensation decisions, including in setting performance metrics.

D&O coverage

In times of financial stress, legal and governance officers frequently field questions from directors and executives about the quality of the company’s D&O coverage. Below are some key questions to consider (which we discuss in more detail here).

- Does the company have a single “ABC tower” that provides coverage for directors and officers (Side A), coverage for the company’s indemnification obligations (Side B) and coverage for other claims against the company (typically securities class actions) (Side C)? If so, a bankruptcy court may decide that the proceeds from the policy are also

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property of the estate—potentially limiting coverage to directors and officers. And whether or not the company is in bankruptcy, the policy may be exhausted by the company's claims, leaving the directors and officers without coverage.

    - Consider purchasing additional standalone Side A coverage.
    - Include well-drafted priority-of-payments clauses to ensure that Side A coverage must be paid before other coverages.

- What happens if a company is bankrupt and unable or unwilling to pay its retention (i.e. deductible), which the insurer could use as grounds to deny coverage?
    - This problem can be addressed by expressly making Side A coverage fully available in the event of "financial impairment," which should be defined to include a broad range of bankruptcy and insolvency scenarios.
- Does the "insured vs. insured" exclusion carve out suits by a bankruptcy trustee or similar entity on behalf of the company?
- Do the "prior knowledge" provisions impute knowledge of wrongdoing to innocent directors and officers?
- Are bankruptcy proceedings carved out of the change-in-control provisions?

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