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# *Proactive Recommendations to Private Equity Sponsors During Debt Ceiling Uncertainty*

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Like most other enterprises that raise and spend capital, the federal government finances its spending in part through the issuance of debt. The federal debt limit is the maximum amount of money that the federal government is allowed to borrow to meet its legislatively mandated spending obligations, as originally enshrined in the Second Liberty Bond Act of 1917. The Bipartisan Policy Center projects that, absent legislative action on the debt ceiling, the United States Treasury will lack sufficient cash to meet current obligations sometime between early June and early August 2023. The Treasury Department itself has warned that day may come as early as June 1. If the federal government reaches the debt limit without amendment, it will no longer be able to borrow money, and because the federal government operates at an annual deficit and is reliant on issuing bonds, it would inevitably default on certain of its obligations.

Bipartisan rancor that hampers federal debt ceiling negotiations, combined with the specter of government default, will have both short- and long-term impacts on various sectors of the economy. This Client Alert focuses on key considerations relevant to the private equity community:

- *Acquisition Agreements*. While the challenging financing environment continues to pose multiple obstacles for private equity investors, sponsors should consider whether and how to allocate the risk of government default – and its resulting impact on both the target company's operations and the buyer's ability to obtain debt financing – as between buyer and seller in the M&A context. In particular, deal parties should consider whether to address the risk of government default within the definition of "Material Adverse Effect" – which can impact both the buyer's obligation to close and its post-closing recovery rights. Buyers should also carefully consider the impact of the issue on R&W insurance (as a potential exclusion).

- *Debt Financing*. Financial sponsors should prepare for uncertainty in the debt markets, whether in the context of acquisition financings, refinancings or existing financings.
  - For acquisition financings, sponsors should expect that financing sources will be more likely to diligence exposure to the federal government. Sponsors should consider incorporating into commitment letters automatic extensions to the outside date for pending government filings or approvals (which may take longer in the event of a government default or shutdown). As discussed above, private equity buyers and their financing sources should expect to bear the risk of adverse consequences arising from a default if sellers expressly exclude such impact from the definition of "Material Adverse

Effect". Finally, to the extent applicable syndication efforts are not successful, arrangers may seek to flex financing terms in applicable commitment papers. Sponsors may wish to consider requesting that arrangers delay launching a syndication process to avoid the imposition of flex.

  – For uncommitted and other "best efforts" financings, arrangers and lenders will have more flexibility to decline to consummate these types of financings if the credit group has exposure to the federal government. Sponsors should review all of the representations and warranties in their documents to ensure they can be made at closing in the event of a government default.

  – Borrowers should consider the impact of a federal government default on availability, as well as on compliance, reporting and drawdown requirements under their existing credit facilities. Borrowers that draw down on their revolvers will need to ensure the accuracy of their representations and warranties and that any leverage governors are satisfied. To the extent availability is governed by a borrowing base, borrowers will also need to confirm that no deductions need to be made on account of a default or shutdown. Borrowers should also review their affirmative covenants to confirm whether there are any applicable reporting requirements, for example, regarding MAE reporting. Borrowers may also have obligations to their financing sources to report on the potential impact of a default or shutdown on performance.

- *Impact of Potential Downgrade in Credit Rating of U.S. Treasury Obligations*. Private equity sponsors should pay attention to any obligations they or their portfolio companies may have – whether tied to liquidity requirements or otherwise – which could be impacted by a downgrade in the credit rating of government obligations, as well as the potential impact on the credit rating of commercial paper issued by companies that may be required to hold more highly rated debt. In the event of an actual or potential downgrade of the credit rating of government debt, private equity sponsors of existing funds may no longer be able to treat such investments as cash equivalents under the limited partnership agreements of such funds. Such funds will also be subject to risk of loss from any government obligations or commercial paper, which are likely not contemplated or disclosed when the funds were raised. Furthermore, the threat of a government default could push interest rates higher and significantly increase overall borrowing costs, further hamstringing fund performance. Sponsors may consider proactively communicating with their limited partners regarding these issues and their anticipated impact on fund performance. For funds actively raising capital, new potential risk factors should be considered.

- *Government Contracts*. Funds should assess whether their portfolio companies and their respective customers and vendors rely on critical agreements with federal agencies. The federal government's inability to raise capital, even temporarily, could impact the ability of government counterparties to make scheduled payments or provide services in a timely manner. The counterparties to government contracts may have limited remedies under such agreements, due to both the identity of the counterparty as a government agency and the underlying cause of the default.

- *Derivatives, Volatility, Hedging and Counterparty Credit Risk*. A default would likely exacerbate foreign exchange and interest rate volatility, and stress the financial institutions that provide liquidity to sponsors. Sponsors whose portfolio companies are unhedged may find it useful to

evaluate interest rate swaps, caps or swaptions – many of which are likely permitted under current leverage facilities. At the fund level, sponsors with unhedged non-USD investments may consider forex “costless collars” or forwards to mitigate a sharp decrease in the relative value of the U.S. Dollar. Even absent a debt default, these strategies are likely worth evaluating given current macroeconomic trends. Additionally, sponsors with over-the-counter derivative exposure to banking institutions should consider whether their exposure to more risky institutions is too concentrated.

The last time that the United States reached a similar impasse over the federal debt ceiling was during the summer of 2011. While the government ultimately averted default twelve years ago, S&P downgraded the United States’ credit rating for the first time in history and equity capital markets were roiled. Please reach out to us to discuss any concerns or questions you may have regarding the federal debt ceiling negotiations or their impact on your fund or its portfolio companies. The Paul Hastings team is ready to assist.

*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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