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CLIENT ALERT

WHAT HAPPENS WHEN THE DEBT CEILING IS REACHED?

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As has been widely reported in the press, Secretary of the Treasury, Timothy Geithner has stated that the deadline for raising the debt ceiling is August 2, 2011, which is the date after which Treasury can no longer pay all of its bills. What happens if Congress does not raise the debt limit before that date? The easy (and not-so-useful) answer to this question is that no one knows for sure. Although there have been periodic debt limit impasses between Congress and the Executive Branch, there is no precedent for the United States Government having insufficient cash to pay all of its bills. We summarize below what could occur in the event Congress does not raise the debt ceiling by August 2, 2011, from a "worst-case scenario" to a scenario in which payments will be prioritized by the Government for the short term.

I. What Is The Debt Ceiling?

The debt ceiling is the statutory limit set by Congress upon the face value of obligations whose principal and interest is guaranteed by the United States Government. 31 U.S.C. § 3101. Currently, the statutory debt limit is approximately $14.3 trillion. Although the federal debt reached its statutory limit on May 16, 2011, the Department of the Treasury has taken extraordinary measures to extend its borrowing capacity. However, such extraordinary measures will be exhausted on or about August 2, 2011.

II. Distinction Between Reaching Debt Ceiling and A "Government Shutdown"

As you may recall, earlier this year, the Federal Government came very close to a shutdown of its operations as a result of the near-failure of Congress to agree on a budget deal. In a "shutdown" scenario, there is an absence of appropriated funds for the Federal Government to conduct most of its operations. In contrast, if the debt ceiling is reached, there is no lack of appropriated funds. Instead, there is a crisis in the Government's cash flow -- that is the Government can only spend what it has available in cash. Therefore, reaching the debt ceiling does not, by itself, require the Government to shut down, nor does it mean that the Government cannot continue to obligate funds or award contracts. Indeed, even if the debt ceiling is reached, the Government is likely to require contractors to continue working on contracts that are already awarded, or proceed on work for contracts that are to be awarded.

III. Worst Case Scenario of a Failure To Raise the Debt Ceiling Default

On April 25, 2011, Matthew Zames, a managing director at JPMorgan Chase, who, in his capacity as Chairman of the Treasury Borrowing Advisory Committee, wrote a letter to Secretary Geithner outlining his fears of what might occur if the debt ceiling is not raised. This letter provides a good summary of the worst-case scenario if Congress does not raise the debt ceiling. Mr. Zames stated that "any delay in making an interest or principal payment by Treasury even for a very short period of time would put the U.S. Treasury and overall financial markets in uncharted territory, and could trigger another catastrophic financial crisis." If there were to be a default on Treasury's obligations, Mr. Zames identified five consequences:

- Reduction by foreign investors of Treasury purchases, and perhaps a sale of existing holdings
- A downgrade of the U.S. sovereign credit rating
- A run on money market funds like the similar run in September 2008 after the Lehman Brothers collapse. "Such a run would spark a severe crisis, disrupting markets and ultimately necessitating the same kind of backstops that Treasury and the Federal Reserve initiated in the aftermath of the 2008 crisis."
- Disruption of the $4 trillion Treasury financing market, resulting in a sharp increase in interest rates, and a sharp drop in overall lending in the credit market.
- The rise in borrowing costs and contraction of credit would damage the economy, potentially pushing the economy back into recession.

IV. Non-Worst Case Scenario: No Immediate Full-Scale "Default" but Short-Term Prioritization of Payments

If Congress does not raise the debt limit before recessing on August 5, 2011 (the scheduled recess date), some observers have suggested that Treasury would likely prioritize payments for various programs; that is, pick "winners" and "losers" among those who are owed payment by the Government. By prioritizing payments, in theory, the Government could at least pay interest on U.S. Treasuries and make payments on certain programs that are deemed to be of highest priority, but delay payments on many federal programs of lesser priority. Although the legal authority of the Government to prioritize payments has been challenged by some observers, it nevertheless appears to be the most likely immediate outcome because there are few, if any, other available alternatives to the Government.

The Bipartisan Policy Center has produced a Debt Limit Analysis (July 2011), which demonstrates the trade-offs when certain payments are prioritized over others. The Bipartisan Policy Center projected for the month of August 2011, $203 billion in revenue inflows, with $363 billion in outflows, resulting in a deficit of approximately $160 billion. Thus, in the absence of an increase in the debt ceiling, in the month of August 2011, should the Government prioritize selected big-ticket programs (interest on Treasury securities, Social Security benefits, Medicare/Medicaid payments, defense vendor payments, and unemployment insurance benefits), the Government would spend $172.7 billion for August 2011. However, this would mean that $134 billion in other programs could not be funded, including military duty active pay, federal employee salaries and benefits, food stamps, the Small Business Administration, the Department of Justice, and many others.

However, the Bipartisan Policy Center concluded that handling all payments for important and popular programs would quickly become impossible, likely resulting in:

- 44 percent cut in federal spending
- Unpaid service providers, such as Medicare/Medicaid providers and defense vendors
- Individuals not receiving government checks
- Uncertainty because Government payment decisions are made day to day.

If that were not enough, almost $500 billion in debt matures in August 2011, which normally would be "rolled over" into new securities. To accomplish this task, if the debt limit is not raised, it is likely that Treasury would either have to pay higher interest rates to attract buyers, or the buyers would not appear. This would further exacerbate the Federal Government's cash flow crisis.

On July 12, 2011, President Obama was quoted in an interview with CBS as stating that Social Security, disability, and veterans' benefits might not be paid in early August if the debt ceiling is not raised. Although this statement was likely made for the purpose of putting pressure on Congress in the ongoing debt ceiling negotiations between Congress and the Executive Branch, it perhaps may serve as a signal of how the Administration plans to prioritize payments in the event that the debt ceiling is not raised. On the other hand, delaying Social Security payments would be a politically difficult decision to make, so it is possible that, in the end, such payments will have priority over others.

V. Will Government Contractors Be Paid?

This is a question that is impossible to answer for sure. If the Government prioritizes certain payments over others, some contractors will be paid in a timely fashion while others will be delayed. Thus, contractors should be prepared for the likelihood that payments on their contracts will be delayed by the Government until the debt ceiling is raised. Although some speculate that vendors for the Department of Defense will likely have a higher priority over contractors for other agencies, there is no way to be sure that will, in fact, be the case.

However, there are potential legal remedies for delayed payments by the Government. To the extent that there are delays in payments to contractors by the required date, the Government may be required to pay interest penalties to contractors under the Prompt Payment Act, 31 U.S.C. § 3902. Moreover, if delays in payment are protracted in length, contractors can perhaps bring contract claims against the Government. That said, even if legal claims against the

Government for breach of contract are valid in this situation, they may not be a sufficient remedy for some contractors who may have their own cash flow problems as a result of delayed contract payments by the Government. Therefore, contractors should, to the extent that they are able, plan ahead for the possibility that contract payments could be delayed starting in August -- for perhaps a few days or possibly a more protracted period of time.

VI. What Are Some Steps That Contractors Can Take To Minimize Their Exposure If The Debt Ceiling Is Reached?

Again, because reaching the debt limit is not an event that has previously occurred, this question cannot be answered with any certainty, and the needs of one particular contractor will differ from another. However, it is predicted by many that interest rates will likely rise when the debt ceiling is reached. Contractors may wish to contact their financial institutions to determine whether arrangements can be made now that would extend currently favorable interest rates for a longer period of time. In addition, there is anecdotal evidence that some contractors are already retaining significantly higher amounts of cash in order to ease any potential cash flow difficulties if there are delays in payment by the Government.

In addition, prime contractors and subcontractors should check the terms of their subcontracting agreements to verify whether subcontractors are to be paid when the prime contractor is paid or under some other terms. In any event, contractors and subcontractors should be in communication with each other about their respective rights and responsibilities, in the event of the Government delaying or missing payments.

Further, in the event that there are delayed payments by the Government, the contractor should send notice to the contracting officer that the Government has, in fact, delayed or missed a payment. Such notices are important both in terms of papering any future contract claims and in keeping the contracting officer informed, as he/she may otherwise be unaware of any delays in payment.

Finally, in the event that the Government is forced to prioritize payments, some contractors are contemplating the possibility of accepting partial payments or giving the Government discounts for early payments as an incentive for the Government to avoid delayed payments. This is a strategy for encouraging immediate payment that contractors may wish to consider, depending upon their own cash flow needs.

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We hope this analysis is helpful to you. Please do not hesitate to contact us if you have any further questions.