ALERT MEMORANDUM

New York State Legislature Considers Sovereign Debt Restructuring Legislation

June 7, 2023

New York is currently considering three proposed laws with potential implications for sovereign debt, which seek to (i) create a comprehensive mechanism for restructuring sovereign debt; (ii) expand the champerty defense; and (iii) limit recovery on sovereign debt claims where the sovereign is participating in certain international initiatives.[1]

All three proposals—which have not been enacted to date— have important potential ramifications since New York law governs over 50% of sovereign bonds issued worldwide. Since there is no international bankruptcy or insolvency regime for sovereigns, sovereign debt restructurings today largely rely on contractual collective action clauses ("CACs") through which bondholders agree to be bound by a restructuring proposed by a sovereign if a specified supermajority of holders approves the proposal.[2] CACs are included in over 95% of foreign law-governed sovereign bonds (by principal amount) and have proven to be effective in reducing the risk of "holdouts" in sovereign debt restructurings. But CACs do not completely eliminate holdout risk. Moreover, CACs are generally absent from non-bonded sovereign debt instruments, which limits their ability to provide a comprehensive sovereign debt solution. Given these shortcomings and soaring sovereign debt levels following the COVID-19 pandemic, there is a renewed impetus for innovations in the sovereign debt restructuring process.

The proposed laws, which have garnered significant media attention,[3] seek to address some of the challenges that sovereigns face when seeking to restructure their debt, including in particular the efforts of some holdout creditors to frustrate or circumvent the consensual resolution of a sovereign debt crisis. However, there are a number of legal and practical concerns that may limit their effectiveness or usefulness to sovereign debtors, and may lead to the migration of sovereign debt, including existing debt, away from New York law to laws of other jurisdictions.

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[1] Assembly Bill A2102A/Senate Bill S5542; Assembly Bill A5290/Senate Bill S5623; and Assembly Bill A2970/Senate Bill S4747.
[2] For more information regarding CACs, *see* Andrés de la Cruz and Ignacio Lagos, *CACs at Work: What Next?: Lessons from the Argentine and Ecuadorian 2020 Debt Restructurings*, 16 CMLJ2, (2021).
[3] *See*, for example, https://www.ft.com/content/fd5f128a-609c-4e3f-bde6-3432b412288a

RESTRUCTURING MECHANISM

This proposed law seeks to superimpose a CAC-like collective voting scheme to a wide array of New York law-governed debt claims. It can be used by sovereign nations or certain "subnational unit[s]," a term which excludes municipalities covered by the U.S. Bankruptcy Code but is not further defined, so possibly could include state-owned enterprises.[4]

- **Petition**: The sovereign files a petition certifying *inter alia* that its debt is unsustainable, it will abide by the mechanism terms, and it is working with the IMF to devise a "path back to sustainability."[5] The sovereign has 30 days to provide notice to all known creditors.
- **Plan**: The sovereign submits to creditors a proposed plan that would make its debt sustainable, which designates classes of claims and specifies treatment of each class (treatment must be the same within each class unless the holder agrees to lesser treatment). There are various restrictions on which claims can be classed together and the sovereign must disclose claims not included in any class. The sovereign may also submit alternative plans from time to time.
- **Voting**: If approved in each class by holders of at least two-thirds of claims by amount and over half of claims by number, the plan binds the entire class and the sovereign is discharged from all New York law-governed claims except as the plan provides.
- **Independent Monitor:** Whereas the original proposal required a comprehensive audit, the amended version calls for appointment by the New York state Governor of an independent monitor who is "acceptable"[6] to the sovereign and holders of the majority of its New York law claims. This individual is empowered to dismiss a petition for lack of good faith. They also prepare and maintain a list of creditors and verify claims for voting purposes (to be reconciled against the sovereign's records).
- **New Borrowings**: If the sovereign borrows to finance the restructuring, it must notify all known creditors of its intention to borrow, the terms and conditions, and the proposed use of proceeds. Creditors have 30 days to respond. The borrowing must be approved by at least two-thirds of respondents by amount.[7] Approved borrowings must be repaid before any other New York law debt.
- **Disputes:** If disputes arise, the independent monitor may request that a court of competent jurisdiction appoint a referee or special master to make recommendations.

The proposed law assumes jurisdictions outside of New York could enact similar laws, and purports to apply across such jurisdictions, although it is unclear how this would work in practice.[8]

The mechanism is an "opt-in" regime on an all or nothing basis—a sovereign that opts in has no discretion over which New York law-governed debt to submit.[9] Creditors may demand *ex ante* commitments that the sovereign will not opt in (the enforceability of which is unclear). Market participants may also require that sovereigns issuing new debt (or seeking relief under existing debt) do so under the laws of non-New York jurisdictions. The out-of-pocket costs of making such a switch could be considerable, even for sovereigns who never use the mechanism.

[4] Assembly Bill A2102A § 301.
[5] *Id.* § 302.
[6] *Id.* § 301.
[7] For priority of repayment to apply, the borrowing must also be approved by "creditors holding at least two-thirds in principal amount of the covered claims" of respondents. *Id.* § 306(4).
[8] The proposed law is limited to debt governed by New York law and therefore would not cover loans made by the Chinese Government, the largest lender to emerging market sovereigns, nor would it apply to official sector debt.
[9] Relatedly, creditors whose claims would not fall within the mechanism can choose to opt into it.

To make the mechanism binding, the proposed law would retroactively modify the debt contracts by inserting the statutory collective voting mechanism and overriding any existing CACs. The supermajority thresholds may be less protective than existing CACs, which are well-established in the market as the best tool for minimizing the cost and disruption of a sovereign debt restructuring and which reflect input from various stakeholders that has coalesced over time. And non-CAC creditors could now be subject to being "crammed down" by binding collective voting through the proposed law.

Regarding the independent monitor, even sovereigns who have accepted the role of New York courts and the IMF may be hesitant to cede control to an unknown individual who may have little expertise and is subject to political change. The mechanism also diminishes the well-accepted role of the IMF in sovereign debt restructurings—for example, here the sovereign self-certifies the unsustainability of its debt rather than undergoing an IMF debt sustainability analysis.

The requirement of repayment of new borrowings made to finance the restructuring before other New York law-governed claims means this "priority" debt would have limited utility and would complicate repayment of existing debt. In addition, a participating sovereign would be required to go through the creditor notice and approval process for a potentially wide swath of new borrowings.

Since the proposed law does not automatically stay enforcement proceedings, sovereigns are subject to the same litigation risk as with their current contractual restructuring tools such as CACs. Indeed, some creditors may be quicker to bring litigation before the sovereign opts into the regime or a proposed debt modification is approved, causing a ripple effect as other creditors file litigation so as not to be left behind.

The proposed law is also subject to a number of potential legal challenges:

- **Jurisdiction**: In the event of a dispute, a court must have subject matter jurisdiction—the power to hear the dispute—and personal jurisdiction—the power to bind a party to its ruling. Absent jurisdiction, a creditor would effectively not be bound by a supermajority vote due to lack of enforceability. Many creditors worldwide would likely be out of the court's jurisdictional reach and even some New York law-governed debt instruments lack clauses submitting disputes to the jurisdiction of New York courts. It is also unclear how the proposed law could be allowed to displace the sovereign's waiver of immunity to New York court jurisdiction.
- **Contract Impairment:** The proposed law applies retroactively to existing contractual relationships, thus raising a possible substantial impairment issue under the U.S. Constitution's "contracts clause." If the proposed law impaired collateral, secured creditors would have a strong ground for challenge as courts are reluctant to adversely affect property rights on a retroactive basis.
- **Preemption**: The U.S. Constitution's "supremacy clause" invalidates state laws that "interfere with, or are contrary to," federal law. Here, based on the federal Bankruptcy Code, the proposed law may be vulnerable to field preemption, which arises when there is a comprehensive scheme of federal law on a topic. Challengers could argue that the U.S. Bankruptcy Code's silence on sovereign insolvency reflects Congress's intent for sovereigns to have no insolvency mechanism.
- **Legislative Taking:** The U.S. Constitution's "takings clause" protects against state action depriving property rights. The proposed law could be a taking to the extent it deprives rights as they existed at the time of buying the debt and retroactively interferes with investment-backed expectations.

- **State-law deficiencies:** A state law touching on treatment of sovereign debt and recognition of sovereigns could be subject to attack as infringing on the exclusive federal prerogative in the realm of foreign relations. Moreover, a state law does not and cannot incorporate features of the U.S. bankruptcy process that facilitate the implementation of an approved bankruptcy plan, such as exemptions from the U.S. securities laws.

CHAMPERTY

New York Judiciary Law Section 489 prohibits a person or entity from acquiring debt "with the intent and for the purpose of bringing an action or proceeding thereon," subject to certain limitations.[10] For debt that trades on a secondary market, this provision only applies where there is an aggregate purchase price under $500,000. Moreover, the statute is not violated where "the primary purpose of the suit is the collection of the debt acquired," *i.e.*, rather than acquiring an instrument solely to bring litigation, acquiring it to collect on a debt (even if that entails litigation).[11]

The proposed law would make three main changes to Section 489:

- Eliminating the $500,000 threshold for sovereign debt;
- Allowing a plaintiff's "intent and purpose" in bringing a sovereign debt claim to be inferred based on its (i) "history of acquiring claims at significant discounts . . . and bringing legal actions to enforce those claims"; (ii) refusal to participate in a settlement accepted by at holders of at least two-third in outstanding amount of similar claims; and (iii) other "facts or circumstances" a court may find relevant;[12]
- Imposing a "duty" on a sovereign debt claim holder "to participate in good faith in a qualified restructuring," *i.e.*, a restructuring accepted by a specified supermajority of holders where a sovereign's debt has been deemed unsustainable by the IMF.[13]

Courts' narrow interpretations of Section 489 have largely eliminated it as a litigation defense for sovereigns. The proposed law could resurrect it but perhaps at the cost of reducing liquidity of sovereign debt in the secondary market.

In addition, the supermajority thresholds specified in the proposed legislation as proxies for determining holdout status are lower than some common CAC thresholds, meaning that even where a CAC restructuring fails, so long as it reaches a certain threshold of votes, a creditor could be precluded from bringing a claim.

LIMITATIONS ON RECOVERY

The proposed law limits recovery on claims against sovereigns participating in certain international initiatives aimed at providing debt relief. Such claims would only be recoverable where burden sharing standards and robust disclosure standards are met. Moreover, recovery would be limited to what would be recoverable "under the applicable international initiative if the United States federal government had been the creditor holding the eligible claim."[14]

The enumerated examples of international initiatives—*i.e.*, the IMF and World Bank Heavily Indebted Poor Countries Initiative, the G20 Debt Service Suspension Initiative, and the Common Framework—were aimed at alleviating sovereign debt burdens in light of the COVID-19 pandemic. While they have had varying levels of success, the proposed law seeks to capitalize on them in pursuit of the same goals.

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the above-listed authors.

[10] N.Y. Jud. Law § 489.
[11] *Elliott Assocs., L.P. v. Banco de la Nación*, 194 F.3d 363, 372 (2d Cir. 1999).
[12] Assembly Bill 5290 § 2.
[13] *Id.* § 3.
[14] Assembly Bill 2970 § 287-b.