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ALERT MEMORANDUM

New York State Legislature Revives Sovereign Debt Restructuring Proposals

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The New York State Legislature is again considering a proposed law with potential implications for sovereign debt. Entitled the "Sovereign Debt Stability Act," it combines two previous legislative proposals from the 2023 legislative session.[1] Those proposals sought to: (i) create a mechanism for restructuring sovereign debt, and (ii) limit recovery on claims against sovereigns participating in certain international debt relief initiatives.[2] Under the new proposed law, a sovereign debtor with New York law governed debt obligations can opt into one of these two mechanisms.

Like its predecessors, the new proposed law has garnered significant attention, given that New York law governs over 50% of sovereign bonds issued worldwide.[3] Since the two proposals incorporated into the proposed law are substantially unchanged from the versions that were considered in 2023, the new proposal shares the legal and practical shortcomings of those prior proposals, as summarized in our past alert. As a result, and although the supporters of the proposed law appear well-intentioned, the considerable legal challenges that the proposed statute would engender, and its significant shortcomings may limit its usefulness and may lead to the migration of sovereign debt away from New York law to laws of other jurisdictions.

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[1] The new 2024 proposal is Senate Bill S5542-A and Assembly Bill A2970-A. The 2023 proposals—Assembly Bill A2102A/Senate Bill S5542 and Assembly Bill A2970/Senate Bill S4747—did not proceed beyond their respective committees.
[2] A third proposal during the 2023 legislative session—Assembly Bill A5290/Senate Bill S5623—would have made certain changes to New York State law on asserting champerty defenses. Those changes are not included in the new 2024 proposal.
[3] International Monetary Fund, *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors – Recent Developments, Challenges, and Reform Options* 22 n.27 (Sept. 23, 2020), https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/09/30/The-International-Architecture-for-Resolving-Sovereign-Debt-Involving-Private-Sector-49796.

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Background

In light of soaring sovereign debt levels following the COVID-19 pandemic, the lack of an international bankruptcy or insolvency mechanism for sovereign debtors has drawn increased attention. Most sovereign debt restructurings today largely rely on contractual collective action clauses ("CACs") to restructure bonded debt, and consensual agreements with creditors who hold other debt. In a typical CAC, bondholders agree to be bound by a restructuring proposed by a sovereign if a specified supermajority of holders approves the proposal.[4] But CACs do not completely eliminate the risk of bondholders choosing to "hold out," and they are generally absent from sovereign debt instruments other than bonds, which prevents them from serving as a comprehensive sovereign debt solution.

Against this backdrop, since 2021 certain New York legislators have repeatedly sought to introduce legislation aimed at providing relief for sovereigns with New York law governed debt obligations. These legislators try to leverage the fact that New York law governs the majority of sovereign bonds issued worldwide to superimpose a CAC-like restructuring mechanism into New York-law debt instruments, whether applying to bonded debt or other debt instruments. So far, all of the proposals have lapsed with the end of the legislative session, and none has been enacted into law.

The latest proposal in the 2024 legislative session combines two of the three lapsed proposals from 2023—the restructuring mechanism and the limitation on recovery mechanism. This proposal allows a sovereign debtor to choose one of the two mechanisms. To do so, the sovereign debtor would file a notice with New York State and must notify creditors of its election within 30 days of filing. The sovereign debtor may change its election once, any time before a plan under the mechanism becomes effective and binding. A sovereign debtor cannot waive its right to elect the treatment of claims under the proposed law.

The Restructuring Mechanism Option

The restructuring mechanism is a CAC-like collective voting scheme with the following elements:

— **Petition:** In its notice to the state, the sovereign would certify *inter alia* that: (i) it has not previously sought relief under this mechanism or another similar law in the past five years; (ii) it has enacted any national or subnational law required to effectuate the restructuring; (iii) without relief, its debt would be unsustainable; and (iv) it is working with the International Monetary Fund ("IMF") to devise a path back to the sustainability of its debts.

— **Independent Monitor:** The New York State Governor would appoint an independent monitor that is "acceptable" to the sovereign and holders of the majority of its New York-law claims.[5] The independent monitor 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). In doing so, the independent monitor may request documentation evidencing the sovereign's enactment of required national laws. Under the new proposal, the sovereign debtor would bear the independent monitor's costs, and the appointment must occur in consultation with the U.S. Treasury Department.

— **Plan:** The sovereign would submit to creditors a proposed plan that would make its debt sustainable, and may submit alternative plans from time to time. Typical methods of restructuring are expressly contemplated, including: curing or waiving defaults, extending maturity dates, modifying payment terms (including the principal and interest rate), and canceling or amending liens.

[4] 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 CMLJ 2 (2021).

[5] The proposed law does not specify whether the independent monitor must be acceptable to a majority of holders of New York-law claims by amount or by number, and it is silent on the procedure if there is no agreement on an independent monitor.

The plan must designate classes of claims and specify 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. Unlike the 2023 proposal, claims of governmental or multi-governmental entities must be classified separately from claims of private creditors.

— **Voting:** If approved in each class by holders of at least two thirds of claims by amount and over half of claims by number entitled to vote, the plan would become binding, and the sovereign would be discharged from all New York law governed claims except as the plan provides. Unlike the 2023 proposal, claims owned by the debtor state or entities that it controls do not count toward approving a plan.

— **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 of the borrowing, and the proposed use of proceeds. Creditors have 30 days to respond to the independent monitor. The borrowing must be approved by at least two thirds of creditors that respond to the independent monitor, by amount of covered claims (i.e., claims governed by New York law or similar mechanisms), without regard to classes of claims. Approved borrowings must be repaid before other New York-law debt.

— **Disputes:** The independent monitor may request a court-appointed referee or special master to make recommendations in the event of a dispute.

The Limitation on Recovery Mechanism Option

This mechanism limits recovery on claims against sovereigns participating in certain international initiatives for 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 by the United States federal government under the applicable international initiative."

"International initiative" includes, for example, the IMF and World Bank's Heavily Indebted Poor Countries Initiative, the G-20's Debt Service Suspension Initiative, and the Common Framework for Debt Treatments. These initiatives aimed to alleviate sovereign debt burdens due to the COVID-19 pandemic, with varying success. The proposal seeks to capitalize on them in pursuit of the same goals.

Practical and Legal Challenges

Since the two proposals are largely unchanged from the 2023 versions, they entail many of the same practical and legal challenges. For one, each mechanism is an "opt-in" framework on an all-or-nothing basis—a sovereign that opts in lacks discretion over which New York law governed debt to submit, reducing flexibility in a restructuring. Meanwhile, the sovereign's right to change its election between the two mechanisms in the middle of a restructuring could delay the restructuring's completion.

The proposed law assumes that 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. Instead, the effect could be a migration of sovereign debt away from New York. Market participants may 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, and are likely to hit sovereigns who have never defaulted on their debt, as well as others that may be more vulnerable to future defaults. Additionally, the migration of sovereign issuers away from New York law could further fragment the mix of debt and jurisdictions that sovereigns utilize to address their borrowing needs, and the resulting partial application of the New York mechanisms would complicate a future restructuring.

Even before a potential migration from New York law, the proposal by its own terms would not cover the vast majority of sovereign debt. In addition to debt governed by other jurisdictions' laws, the proposed law would not apply to non-New York-law debt, including local law governed debt, official sector debt

or loans by China and its state-owned banks. Private sector creditors account for only about one third of sovereign debt for low- and middle-income countries (excluding China) and approximately one fifth of debt for the poorest countries.[6] Despite reducing lending recently, China has been the largest lender to the developing world and has, so far, proven reluctant to participate in international initiatives for debt relief.[7] The proposed law thus neglects one of the biggest challenges facing sovereigns today when it comes to restructuring their debt—namely, how to address the challenges of restructuring official sector and bilateral debt held by state entities who would not be bound by the proposed New York law. Additionally, the proposed law is more likely to reduce, rather than to increase, access to private capital for most emerging-market sovereigns, thereby exacerbating the other major challenge confronting low- and middle-income countries that face increasing expenditure needs and higher borrowing costs.

The restructuring mechanism works by retroactively overriding any existing CACs in favor of its statutory collective voting mechanism. Its supermajority thresholds may be less protective than existing CACs, which are well-established in the market, and thus invite abuse by creditors close to New York State's process. As compared to its 2023 predecessor, the new proposed law broadens the sweep of the restructuring mechanism to override inconsistent contractual provisions. Further, the new requirement in this year's proposal that governmental claims be placed in a separate class may result in those claims obtaining superior treatment than similarly situated private sector debt, a concept at odds with most insolvency laws and the principles of "comparable treatment" espoused by most international organizations focused on sovereign debt management. Finally, the restructuring mechanism does not specify how far up the chain of title the voting of claims would occur, such as whether the trustee or beneficial owners of bonds would vote. The independent monitor cannot carry out its duty to keep a list of creditors and supervise voting on a plan without specific criteria, and its ability to require such information from third parties not subject to the jurisdiction of New York courts seems dubious at best.

Indeed, the role and authority of the independent monitor within the restructuring mechanism also remains ill-defined. The independent monitor's authority and jurisdiction to make information requests is unclear. Practically, 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. Involvement of the U.S. Treasury in the appointment process perhaps is an attempt to mitigate this concern, but does not provide a complete solution. Since the sovereign self-certifies the unsustainability of its debt rather than undergoing an IMF debt sustainability analysis, the restructuring mechanism also diminishes the well-accepted roles of the IMF and other international institutions, which were not consulted in developing the proposal.

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.[8] A participating sovereign would need to go through the creditor notice and approval process for a potentially wide swath of new borrowings, such as: ordinary course central banking, trade financing, derivatives contracts, and local and official sector borrowing. This new borrowing procedure would apply through the proceeding, which could take years given the likely legal challenges the law would engender, should it ever be enacted and

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[6] World Bank Group, *International Debt Report 2023* 4, 6 (2023), https://www.worldbank.org/en/programs/debt-statistics/idr/products.

[7] The Bretton Woods Committee, *Private Sector Engagement and Equitable Burden Sharing: A New Paradigm* 37 (June 2023), https://www.brettonwoods.org/sites/default/files/documents/BWC-SDWG-Paper3-PrivSectorEng-2023-FNL-web1.pdf.

[8] Yet, the seniority of new borrowings would only apply to New York law governed debt, complicating the priority of payment in a restructuring.

used. We suspect that most sovereigns would hesitate to put themselves in such a position (i.e., unable to borrow money) for this reason alone, even if they were otherwise inclined to opt into the statute.

For the limitation on recovery mechanism, the meaning of "recoverable by the United States federal government under the applicable international initiative" is unclear. Within international initiatives themselves, such as the Common Framework for Debt Treatments, interpretations of recovery standards have varied on a case-by-case basis, and there is no one standard or even agreed metric that applies to all situations. The lack of clarity about how to measure the recovery could spark disputes and delay a restructuring. This ambiguous cap on recoveries also ignores the reality that official sector lenders extend credit to fulfill their public policy mandates, while private lenders seek to recoup their investments and obtain, if possible, returns on invested capital for their investors. With their recoveries capped, private sector investors may choose to deploy their capital to other investment opportunities, thereby reducing the overall funding available to low- and middle-income countries whose funding needs have only increased in recent years due to the pandemic, climate change, and higher financing and refinancing costs.

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 proposed new framework or a proposed debt modification is approved, causing a ripple effect as other creditors file litigation to avoid being left behind. Theories for creditors to challenge the proposed law may include:

— **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. Many creditors worldwide would likely be out of the court's jurisdictional reach, and so arguably beyond the binding effects of the proposed law. It is also unclear how the proposed law could be allowed to displace the sovereign's waiver of immunity to New York court jurisdiction.

— **Impairment of Contracts:** 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 retroactively.

— **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, including by canceling liens.

— **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 restructuring plan, such as exemptions from the U.S. securities laws.

Perhaps anticipating such challenges, the proposed law's sponsors made its provisions severable, so that one mechanism can survive if the other is invalidated.

Already, the proposed law has drawn broad opposition from commentators and financial industry groups, including: The American Council of Life

Insurers, The Credit Roundtable, the Investment Company Institute, the International Capital Market Association, the Institute of International Finance, the Life Insurance Council of New York, the Partnership for New York City and the Securities Industry and Financial Markets Association. Those eight groups issued a joint press release condemning the proposed law's consequences, such as regressive increases in borrowing costs that would detract from necessary governmental spending while reducing the value of existing sovereign debt. The groups concluded that the proposal would deal "a major blow to New York law's position as the gold standard for large, global financing transactions."[9]

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The proposed law is a well-meaning attempt to alleviate a particular set of challenges of restructuring sovereign debt. Yet its mechanisms raise their own practical issues, without anticipating the market's response. Instead of solving sovereign debtors' problems, the proposed law could cause a costly migration from New York law. It also fails to address the larger and more significant challenges that typically delay and impede sovereign restructurings today (i.e., dealing with bilateral debt held by countries and multilateral institutions of varying types who have different views on how to restructure defaulted debt), and it may end up limiting, rather than expanding, access to private capital for countries that desperately need that to meet their development and growth objectives.

To avoid that outcome, participants in the market for sovereign debt should study the proposed law and voice their views through counsel to the New York State Legislature and IMF, as well as in the press and other relevant forums.

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

[9] *ACLI, CRT, ICI, ICMA, IIF, LICONY, PFNYC, and SIFMA Oppose New York Legislature Bill on Sovereign Debt* (Mar. 13, 2024), https://www.iif.com/About-Us/Press/View/ID/5701/ACLI-CRT-ICI-ICMA-IIF-LICONY-PFNYC-and-SIFMA-Oppose-New-York-Legislature-Bill-on-Sovereign-Debt.