SOVEREIGN DEBT RESTRUCTURING BILL (ASSEMBLY BILL A2102)

Background:

- The **Sovereign Debt Restructuring Bill (Assembly Bill A2102)** would, retroactively, create a bespoke restructuring regime for New York law-governed sovereign debt.

- Under the bill, an indebted foreign sovereign may elect to opt in to the scheme. There are no criteria specified for determining whether a sovereign is eligible. The process would be overseen by an unspecified "supervisory authority" to be selected by the New York State Senate Finance Committee. No criteria are specified for eligibility to serve as a Supervisory Authority, nor are creditors permitted to object to the authority designated. The debtor would have the exclusive power to propose a restructuring plan; creditors would be unable to propose a competing plan. There are no criteria specified for determining what debt relief the debtor requires or what constitutes a sustainable debt load for the debtor. And there is no prohibition against discriminatory treatment of certain creditors—or in favor of holders of debt not governed by New York law (including debt owed to Chinese lenders).

- The scheme would supervene all contractual provisions governing the restructuring of any debt subject to a restructuring falling under the statute. A restructuring plan becomes binding on a class when "creditors holding at least two-thirds in amount and more than one-half in number of the claims of such class voting on such plan agree to the plan."

The Motivations For The Sovereign Debt Restructuring Bill Are Misguided:

- The stated motivations for the Sovereign Debt Restructuring Bill make little sense. The Sovereign Debt Restructuring Bill's sponsor, Senator Gustavo Rivera, for example, claims that the bill is meant to respond to so-called vulture funds' buying up and profiting from Puerto Rican debt. But the bill applies not just to unincorporated territories and states, but also to foreign countries and provinces.

- Some academics, like Duke Law Professor Steven Schwarcz, have said that state legislation is necessary to resolve a "holdout" problem unique to foreign states that are otherwise not eligible for federal bankruptcy protection. But this hold-out theory doesn't align with reality.

    - The primary incident anyone ever cites of this supposed holdout problem is Argentina's restructuring following its default in 2001. But Argentina's "holdouts" were exercising contractual rights contained in the documents governing their debt, under which they could not be compelled to accept a restructuring proposal. .

    - These conditions no longer hold. The International Monetary Fund (IMF) found in 2020 that "almost all international sovereign bonds include some forms of" collective action clauses that "could help facilitate debt restructurings." Foreign states also revised the pari passu clauses to eliminate holdout rights in bonds issued since 2014.

    - Although some bonds which lack collective action clauses are still in circulation, fewer than 3.6% of sovereign restructurings have led to litigation in the last fifty years. Between 1997 and 2014, 95% of creditors consented to restructurings. More than a dozen countries, provinces, and cities have successfully restructured since 2017. And though many feared that COVID-19 would push countries to "the brink of a new, disorderly default," that didn't happen. Creditors agreed to reasonable repayment terms for Ecuador, Argentina, and several Argentine provinces.

- In fact, the international community has successfully worked over the last several decades to make restructurings increasingly fair, open, and fast. The IMF, other international stakeholders, and the Obama administration spent months crafting the state-of-the-art collective action clauses that now govern almost all new sovereign debt. The proposed legislation would strip these carefully-developed provisions out of the governing debt agreements and replace them with a crude cram-down rule lacking in nuance. When states restructure, the IMF objectively analyzes sovereigns' debt sustainability. The international community considers these analyses to be a "key tool" in helping states avoid future defaults. The market also relies on the IMF's analysis in restructuring negotiations, and market buy-in is necessary if the state wants to borrow money again. Debtor states cooperate with the IMF because it loans money to meet temporary funding needs during restructuring. The proposed bill would end run this process altogether by allowing a sovereign debtor to determine for itself what debt relief it needs and what debt level it can sustain without any oversight or accountability.

- The Sovereign Debt Restructuring Bill ignores the real problem in foreign restructuring because it applies only to debt governed by New York law. That leaves half the world's sovereign debt untouched, much of which is increasingly subject to English or Chinese law. And sovereign debt governed by foreign law is a growing obstacle to orderly restructurings.

    - For example, Chinese bank loans governed by Chinese or English law, which represent a growing part of developing states' obligations, often prohibit states from disclosing the existence or terms of the debts and "exempt" the debts from collective restructuring. This threatens to bog down future restructurings, as Chinese debt makes up 63% of the world's poorest countries' obligations. It has already hindered Zambia's ongoing restructuring.

    - As a result, developing states' worst problems will remain unfixed, and New York bondholders will be worse off than foreign ones.

The Sovereign Debt Bill Will Make Things Worse

- The Sovereign Debt Bill strips important lender protections that exist in the current international regime.

  - Presently, sovereign bonds prevent states from redistributing a minority of creditors' claims to the super-majority by requiring states to offer all bondholders the same terms. The Sovereign Debt Restructuring Bill includes no such protections.

  - Bonds also generally require creditors holding at least 2/3s of all debt to agree to major changes and majority agreement for each bond class, and also determine in advance which creditors vote in each class. The Sovereign Debt Restructuring Bill requires 2/3s creditor consent for each class, but has no aggregate supermajority requirement, and lets states gerrymander creditors' voting pools. So just as politicians redistrict to pick their voters, states will use their voting-pool power to divide and disenfranchise creditors.

  - The Sovereign Debt Restructuring Bill allows states, rather than the IMF, to prepare their own debt sustainability analyses. That's a bit like declaring bankruptcy and naming yourself the bankruptcy judge. Creditors won't trust these self-serving analyses because the bill does not penalize states for asking for more relief than they need.

- Professor Schwarcz has compared the Sovereign Debt Restructuring Bill to a bankruptcy regime, but the bill lacks three important creditor protections that are essential to corporate bankruptcies.

  - In traditional bankruptcy, a judge can approve a corporate restructuring plan only after certifying that the restructuring is in the best interests of the creditors. The bill has no such requirement.

  - Bankruptcy courts can force corporations to make hard choices by threatening liquidation. Creditors lack that leverage with states (which of course can't liquidate).

  - Bankruptcy courts impose deadlines, but this bill encourages delay. The contemplated auditing process will hold up negotiations. The bill likewise gives only states, but not creditors, the right to propose restructuring plans. So a demagogue-led government could submit bad plan after bad plan, only to grandstand back home when lenders refuse to play ball.

- The Sovereign Debt Restructuring Bill introduces substantial uncertainty into the sovereign debt restructuring process. It replaces the IMF, Paris Club, and other international stakeholders with a so-called "supervisory authority" in charge of the restructuring process but does not say who this authority is and reveals very little about the authority's actual powers.

  - The supervisory authority purportedly has the power to dismiss sovereign debt restructuring petitions for lack of "good faith," but does not say what that means.

  - The supervisory authority is required to appoint an outside organization to audit states' debts, expenditures, and income. This audit is new to sovereign restructuring, but the bill gives little detail to its purpose, how it should proceed, or the auditor's duties and powers. The bill does not say, for example, (1) what happens if the state refuses to cooperate with the audit; (2) whether the auditor can label debt illegitimate and reduce creditors' claims; or (3) whether the auditor publishes its findings.

- Making it harder to enforce bond terms against foreign states will raise borrowing costs for New York-issued sovereign debt.

    - The U.S. Court of Appeals for the Second Circuit has singled out this factor before. When it is more difficult to enforce bonds against sovereign states, it is harder for "holders of debt instruments" to sell those bonds on secondary markets. Disrupting the secondary markets in this way makes it riskier, and thus more costly, to lend to high-risk, developing countries.

    - Increasing the cost of New York-issued sovereign debt will just encourage lenders and foreign states to issue debt outside New York, and subject to foreign law. Courts have consistently recognized (at the federal government's urging) that impairing sovereign debt contracts in this way would threaten "New York's status as one of the foremost commercial centers in the world" and, given New York's status as "the international clearing center for United States dollars," the strength of the U.S. dollar, and the U.S. economy.

    - It is hard to predict just how drastically this bill would affect New York's role in the international financial system. No other country in the world has enacted legislation that is anything like this. A few countries, like Britain and France, have enacted legislation requiring bondholders to accept debt reduction deals brokered by the international community. But no country has ever created a bespoke bankruptcy regime along these lines.

The Bill Fails to Address the Real Problem

- The bill also ignores that Chinese lenders are the primary obstacle to sovereign debt restructurings. Since 2008, the Chinese state has restructured the finances of more countries than all the members of the Paris Club combined.

    - Chinese debt accounts for 63% of debt obligations in the world's poorest countries. Most sovereign debt in developing countries is issued under, and much of it is governed by, Chinese law, and subject to enforcement proceedings in China.

    - While most Chinese contracts are shrouded in secrecy, a small sample of contracts with Chinese creditors was systematically analyzed in 2021. The insights revealed were startling. In addition to "unusual confidentiality clauses that bar borrowers from revealing the terms or even the existence of the debt," Chinese lenders seek "seek advantage over other creditors, using collateral arrangements such as lender-controlled revenue accounts and promises to keep the debt out of collective restructuring ("no Paris Club" clauses)."

- The rapid proliferation of Chinese-issued debt including these terms is, by far, the largest impediment to successful sovereign restructuring around the world. The analysis also concluded that "cancellation, acceleration, and stabilization clauses in Chinese contracts potentially allow the lenders to influence debtors' domestic and foreign policies." The early examples of developing countries relying on Chinese lenders serve as clear warnings as to the risks to 1) economic development in borrowing countries and 2) orderly and effective restructuring of sovereign debt around the world.

- China's $6 billion in lending to Zambia— which in 2020 became the first country to default in the COVID-19 era in 2020—has been described as "debt-trap diplomacy", and is fueling ongoing humanitarian crises in the country. Chinese officials have insisted that Zambian debt owned by foreign investors and multilateral lenders should take haircuts as part of Zambia's debt restructuring, and have held up negotiations on this point. Similar dynamics are playing out in Sri Lanka, which defaulted in early 2022. Chinese lenders hold more than $7.4 billion in Sri Lankan debt, or roughly 20% of its public external debt. Restructuring negotiations are underway, but talks have stalled over Beijing's insistence that multilateral lenders (like the World Bank and IMF) also restructure their loans.

- The bill will have no impact on debt to Chinese lenders. Debt governed by Chinese law will not be subject to this legislation by definition. Chinese debt, virtually all of which is subject to enforcement in Chinese arbitral or judicial forums, will also be unaffected, as those forums will undoubtedly decline to enforce this restriction on their creditors' rights. China as a whole is unlikely to become more forgiving towards debtor states because, as *The Economist* explains, (1) writing off a loan requires a lending bank to seek permission from the Chinese government, which results in professional recriminations; (2) China treats its state-owned banks as private creditors and thus not part of international sovereign debt restructuring initiatives; and (3) China fears that waiving their loans' confidentiality terms will encourage more defaults.

- The bill myopically, and incorrectly, assumes that sovereign restructurings are hindered only by New York judicial action, while ignoring these larger international dynamics.

• Finally, the Sovereign Debt Restructuring Bill would create a troubling precedent for federalism. If in fact sovereign debt negotiations should be restructured, that should be a decision made by President Biden, Congress, and the international community, not state legislators.

REVIVED G20 BILL (SENATE BILL S4747)

- The **Revived G20 Bill (Senate Bill S4747)** would add a new article (10-b) to New York's debtor and creditor law in an effort to establish "fair" burden sharing standards for public and private creditors in sovereign debt restructuring. The bill would impose a statutory haircut on the debt to private creditors owed by a sovereign borrower that participates in an "international initiative" targeting sovereign debt relief. The bill would strip carefully crafted collective action and other creditor protection provisions out of sovereign debt agreements to the extent they conflict with the bill's provisions and replace them with vague guidelines which are likely to invite litigation rather than preventing it.

- The bill imposes retroactive restrictions on claims against debtor states that have applied to participate in relevant "international initiatives" in which the U.S. government, other states, and international financial institutions promote debt relief. These initiatives include, but are not limited to, the Heavily Indebted Poor Countries Initiative (HIPC), the Debt Service Suspension Initiative, and the "Common Framework." A debt, guarantee, payment claim for borrowed money, or similar obligation is covered by the bill if it is against a sovereign state participating in a relevant "international initiative."

    - First, the bill would permit recovery by creditors against foreign states only to the extent that they "comport with burden-sharing standards" set the by relevant international initiatives. It is not clear what this requirement means, or under what circumstances a foreign state could claim that a creditor has a claim that fails to "comport" with those burden-sharing standards.

    - Second, creditors could recover only if their claims meet "robust disclosure standards, including inter-creditor data sharing." It is unclear what these requirements would entail, or under what circumstances a foreign state could challenge a creditor for failing to meet "robust disclosure standards." Nor is it clear what problem this is intended to address. While lack of transparency from Chinese lenders is widely acknowledged as a severe obstacle to successful restructurings, holders of New York law governed sovereign debt represent no such problem.

    - Third, the bill would cap the maximum recovery for any claim by prohibiting any creditor from recovering more than the amount permitted under the relevant international initiative. This would include retroactively reducing any judgment awarded to a sovereign creditor in proportion to any debt reduction agreed to or imposed as part of such an initiative.

- The bill is ill-suited to addressing the challenges at which it is aimed. It would radically revise federal and state judgments long since entered against foreign states. The bill will not only fail to deliver economic relief to developing countries, but will raise the cost of lending and harm developing states in the long term.

- The bill, as written, would retroactively reduce federal and state judgments entered against foreign states.
    - The bill applies to any "domestic … judgment with respect to [] a claim" for "borrowed money" or similar "debt-equivalent claim." And the bill's haircut provisions apply to "any eligible claim," including judgments, "incurred prior to the date of an eligible state's application to participate in one or more international initiatives."
    - This provision is almost certainly a per se violation of the Full Faith and Credit and Supremacy Clauses, and for good reason. Even an attempt to retroactively set aside lawful judgments entered on behalf of U.S. funds would deeply undermine the rule of law and New York's reputation as a center for commerce and litigation.
- The bill is outdated because private creditors no longer pose a substantial threat to sovereign debt restructurings. The bill is ostensibly modeled after the United Kingdom's Debt Relief (Developing Countries) Act of 2010. But the bill goes substantially further than the UK's legislation. Furthermore, the landscape of sovereign debt restructuring has shifted markedly since that law was enacted.
    - The UK legislation had limited effect because it was retrospective only, and required creditors to accept haircuts consistent with the IMF and World Bank's HIPC Initiative—which applied only to highly indebted poor countries. The UK legislation did not apply to future restructurings, or to debt issued by non-HIPC states. The New York bill, by contrast, applies to all future international debt restructuring and debt foregiveness initiatives. No country has ever enacted any legislation like this.
    - In the early 2000s, there was a push to enact legislation like the UK's in reaction to "holdouts" refusing to participate in Argentina's restructuring following its default in 2001. But Argentina's "holdouts" were exercising contractual rights contained in the documents governing their debt, under which they could not be compelled to accept a restructuring proposal without their consent. The creditors in this case also secured a "pari passu" injunction prohibiting Argentina from paying other creditors while declining to pay "holdouts."
    - These unique facts have not arisen since, and, as the Second Circuit found when upholding the pari passu injunction, are unlikely to arise again. The International Monetary Fund (IMF) has found, "almost all international sovereign bonds include some forms of" collective action clauses, under which a super-majority of bondholders can vote to agree to restructurings even over holdouts' objections. Foreign states have also revised the pari passu clauses to eliminate holdout rights in bonds issued since 2014.
    - Although some bonds which lack collective action clauses are still in circulation, fewer than 3.6% of sovereign restructurings have led to litigation in the last fifty

years. Between 1997 and 2014, 95% of creditors consented to restructurings. More than a dozen countries, provinces, and cities have successfully restructured since 2017. And though many feared that COVID-19 would push countries to "the brink of a new, disorderly default," that didn't happen. Creditors agreed to reasonable repayment terms for Ecuador, Argentina, and several Argentine provinces.

  - The IMF, other international stakeholders, and the Obama administration spent months crafting the state-of-the-art collective action clauses that now govern almost all new sovereign debt. The proposed legislation would strip these carefully-developed provisions out of the governing debt agreements and replace them with a crude cram-down rule dictated by public lenders and lacking in nuance.

- The bill also ignores that Chinese lenders are the primary obstacle to sovereign debt restructurings. Since 2008, the Chinese state has restructured the finances of more countries than all the members of the Paris Club combined.

  - Chinese debt accounts for 63% of debt obligations in the world's poorest countries. Most sovereign debt in developing countries is issued under, and much of it is governed by, Chinese law, and subject to enforcement proceedings in China.

  - While most Chinese contracts are shrouded in secrecy, a small sample of contracts with Chinese creditors was systematically analyzed in 2021. The insights revealed were startling. In addition to "unusual confidentiality clauses that bar borrowers from revealing the terms or even the existence of the debt," Chinese lenders seek "seek advantage over other creditors, using collateral arrangements such as lender-controlled revenue accounts and promises to keep the debt out of collective restructuring ("no Paris Club" clauses)."

  - The rapid proliferation of Chinese-issued debt including these terms is, by far, the largest impediment to successful sovereign restructuring around the world. The analysis also concluded that "cancellation, acceleration, and stabilization clauses in Chinese contracts potentially allow the lenders to influence debtors' domestic and foreign policies." The early examples of developing countries relying on Chinese lenders serve as clear warnings as to the risks to 1) economic development in borrowing countries and 2) orderly and effective restructuring of sovereign debt around the world.

  - China's $6 billion in lending to Zambia— which in 2020 became the first country to default in the COVID-19 era in 2020—has been described as "debt-trap diplomacy", and is fueling ongoing humanitarian crises in the country. Chinese officials have insisted that Zambian debt owned by foreign investors and multilateral lenders should take haircuts as part of Zambia's debt restructuring, and have held up negotiations on this point. Similar dynamics are playing out in Sri Lanka, which defaulted in early 2022. Chinese lenders hold more than $7.4

billion in Sri Lankan debt, or roughly 20% of its public external debt. Restructuring negotiations are underway, but talks have stalled over Beijing's insistence that multilateral lenders (like the World Bank and IMF) also restructure their loans.

  - The bill will have no impact on debt to Chinese lenders. Debt governed by Chinese law will not be subject to this legislation by definition. Chinese debt, virtually all of which is subject to enforcement in Chinese arbitral or judicial forums, will also be unaffected, as those forums will undoubtedly decline to enforce this restriction on their creditors' rights. China as a whole is unlikely to become more forgiving towards debtor states because, as *The Economist* explains, (1) writing off a loan requires a lending bank to seek permission from the Chinese government, which results in professional recriminations; (2) China treats its state-owned banks as private creditors and thus not part of international sovereign debt restructuring initiatives; and (3) China fears that waiving their loans' confidentiality terms will encourage more defaults.

  - The bill myopically, and incorrectly, assumes that sovereign restructurings are hindered only by New York judicial action, while ignoring these larger international dynamics.

- The bill will make it harder for international initiatives to reach debt restructuring agreements.

  - The bill states in its legislative findings that "public creditors are unlikely to participate in debt restructuring initiatives unless there is fair burden sharing among all public and private creditors." But history has demonstrated the opposite: public creditors have never been deterred from participating in restructuring initiatives based on U.S. and European private creditors' failure to participate.

  - The bill introduces a new imbalance because it applies to all New York debt, public or private, but will not apply to Chinese debt. That will discourage participation in debt restructuring initiatives.

  - The bill will make states less willing to agree to restructurings. The bill forces private creditors to take at minimum the same haircut as the United States does. This will deter the United States from committing to public sector restructurings, as any haircuts it accepts will also harm institutional investors managing U.S. pension funds.

- This bill will raise lending costs.

  - Emerging economies rely on the ability to raise money on the sovereign debt market to fuel their development needs. Investors are willing to purchase this debt because a stable and predictable enforcement system allows them to collect.

    - Altering creditor's rights, particularly through ex post facto legislation, is a disruption that make it riskier, and thus more costly, to lend to the developing countries the bills purport to protect.

    - The fact that the bill applies to *all* international debt restructuring initiatives, including past ones, will worsen this effect. Creditors who have been pressing claims against foreign states after declining to restructure, or agreeing to different restructuring terms, will be forced to accept the same haircut that the United States did in the HIPC Initiative, the Debt Services Suspension Initiative, and every other initiative, even though none of these initiatives were designed with the intention of cramming down restructurings on the private sector.

    - The fact that the bill is ambiguous will also worsen these problems. The requirement that creditors' claims "comport with burden-sharing standards" set the by relevant international initiatives and meet "robust disclosure standards" lack any precedent in U.S. legal practice or the UK legislation this bill is modeled after. This language will just invite countries to raise ambiguous legal challenges even against creditors who voluntarily decide to accept haircuts equal to that taken by the United States.

- This bill will harm New York and the U.S. financial system. Increasing the cost of New York-issued sovereign debt will just encourage lenders and foreign states to issue debt outside New York, and subject to foreign law. Courts have consistently recognized (at the federal government's urging) that impairing sovereign debt contracts in this way would threaten "New York's status as one of the foremost commercial centers in the world" and, given New York's status as "the international clearing center for United States dollars," the strength of the U.S. dollar, and the U.S. economy.

<u>**CHAMPERTY BILL (FORMER ASSEMBLY BILL A9317)**</u>

- The **<u>Champerty Bill (former Assembly Bill A9317)</u>** would eliminate the statutory safe-harbor provision in New York's champerty statute, subject creditors seeking to enforce defaulted sovereign debt governed by New York law to intrusive discovery, and create a presumption that a creditor who has any history of purchasing sovereign debt at a discount or refusing to accept a sovereign restructuring proposal acquired the debt with wrongful intent.
  - Presently, the New York champerty statute cannot be invoked where the creditor can show that it paid at least $500,000 in the aggregate for debt issued by the sovereign debtor in question. Even before the safe harbor provision was enacted in 2004, the champerty defense was not available when a party purchases debt with the goal to sue to enforce the debt absent full performance.
  - The Champerty Bill repeals both of these rules for foreign states, and holds that a foreign state can establish that a creditor's claim is champertous, and thus unenforceable, via evidence of (1) the creditor's (or its affiliates') history of acquiring claims at significant discounts and suing to enforce those claims; (2) the creditor's (or the party it purchased the claim from) refusing to participate in a prior bond restructuring; and (3) any other facts or circumstances the court may deem relevant.
- This Champerty Bill will make it near impossible for bondholders to ever sue a foreign state for defaulting on its debts.
  - The U.S. Court of Appeals Second Circuit has pointed out that, if it were able to invoke a champerty defense, a foreign state could simply declare its "unwillingness to pay, thereby making it plain that no payment would be received without suit. Under such circumstances, prospective purchasers would not be able to acquire the debt instruments without opening themselves up to the defense …."
  - The Champerty Bill would also significantly increase the cost of such lawsuits, because every sovereign bondholder could be subjected to broad discovery into their past investments as a matter of course to determine their champertous "intent."
  - The Champerty Bill introduces an imbalance in sovereign debt restructurings because it does not apply to primary lenders. This means that a U.S. fund investing pension funds will be forced to accept haircuts, whereas Chinese state-owned banks that loaned to sovereigns directly will not.
- Making it harder to enforce bond terms against foreign states will raise borrowing costs for New York-issued sovereign debt.

- The U.S. Court of Appeals for the Second Circuit singled out this factor when interpreting the champerty statute. A robust champerty defense makes it more difficult for "holders of debt instruments" to sell those bonds on secondary markets. Disrupting the secondary markets in this way makes it riskier, and thus more costly, to lend to high-risk, developing countries.

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- It is hard to predict just how drastically this bill would affect New York's role in the international financial system. New York has never had a champerty defense this robust. And no other country in the world has enacted legislation that is anything like this. A few countries, like Britain and France, have enacted legislation requiring bondholders to accept debt reduction deals brokered by the international community. But no country has ever given foreign states a right to evade their obligations by means of a "champerty" defense.

- The bill also ignores that Chinese lenders are the primary obstacle to sovereign debt restructurings. Since 2008, the Chinese state has restructured the finances of more countries than all the members of the Paris Club combined.
  - Chinese debt accounts for 63% of debt obligations in the world's poorest countries. Most sovereign debt in developing countries is issued under, and much of it is governed by, Chinese law, and subject to enforcement proceedings in China.
  - While most Chinese contracts are shrouded in secrecy, a small sample of contracts with Chinese creditors was systematically analyzed in 2021. The insights revealed were startling. In addition to "unusual confidentiality clauses that bar borrowers from revealing the terms or even the existence of the debt," Chinese lenders seek "seek advantage over other creditors, using collateral arrangements such as lender-controlled revenue accounts and promises to keep the debt out of collective restructuring ("no Paris Club" clauses)."
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