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New York Legislature Proposes New Sovereign Debt Restructuring Bill

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The New York State Legislature recently proposed a bill, entitled the Sovereign Debt Stability Act,[1] intended to facilitate sovereign debt restructuring. The bill, which could be brought to a vote as soon as May or June 2024, could have far reaching consequences as New York law governs approximately half of all sovereign bonds issued worldwide.[2] The restructuring framework provided by the Act, if adopted, could compel debt restructurings over dissenting creditors and limit creditor recoveries. This article highlights (i) the context in which the Sovereign Debt Stability Act arises, (ii) its main features, and (iii) potential implications of its adoption below.

I. Context

Sovereign nations (and even US states) face unique challenges when they experience financial distress. Unlike companies, individuals, or municipalities, states do not have access to bankruptcy or similar legal frameworks in the United States or internationally. These states have historically encountered difficulty restructuring their debt because the terms of their documentation enable "holdout" creditors to refuse to negotiate or compromise their claims. The absence of a bankruptcy framework to adjust these debts means the states lack both the leverage and the ability to compel holdouts to compromise.

Various solutions have emerged in response to past sovereign debt crises. In the context of sovereign bond indentures, collective action clauses have become prevalent, allowing a qualified majority of bondholders to compel holdouts to accept a sovereign's restructuring proposal. Additionally, multilateral forums and institutions, such as the Paris Club and the International Monetary Fund (the "IMF"), have played a critical role through debt relief, technical assistance, and other initiatives.

In the exceptional case of Puerto Rico's debt crisis, the US Congress enacted a bespoke statute that granted the island and its instrumentalities access to federal bankruptcy through a proceeding overseen by a federally appointed oversight board. The statute, known as

"PROMESA,"[3] incorporates many provisions from Chapter 9 of the US Bankruptcy Code, which allows municipalities of US states (but not the states themselves) to adjust their debts. The Commonwealth of Puerto Rico, through its oversight board, successfully emerged from bankruptcy in 2022, closing a major chapter in the largest public sector restructuring in US history.[4]

Despite the existing solutions, challenges persist. Collective action clauses do not cover all existing sovereign debt instruments, and government debt portfolios have become increasingly complex. Moreover, in the absence of a bankruptcy-like legal protections such as the automatic stay, countries remain exposed to litigation risk in the event of a default, creating a potential run to the courthouse and impairing their ability to effectively restructure their debt. Finally, a statutory solution at the US federal level, like in the case of Puerto Rico, is not readily applicable to sovereign states, and even its application to US states could be problematic.[5] Due to these issues, and inspired in part by Puerto Rico's restructuring, the Sovereign Debt Stability Act is New York's latest proposal to address some of the remaining challenges.[6]

II. Sovereign Debt Stability Act

The Sovereign Debt Stability Act would introduce "Article 8" to the New York Debtor and Creditor Law, providing relief to sovereign nations, unincorporated territories, and their subnational units (collectively, "debtor states").[7] Provided that the debtor state opts into Article 8 by filing a petition or notice (as further described below), Article 8 would apply to debt obligations subject to New York law.[8] It would also allow holders of debt *not* subject to New York law to voluntarily opt in.[9]

Additionally, because Article 8 is in part based on a model-law project, it contemplates that jurisdictions other than New York may adopt similar statutes, in which case Article 8 would apply across borders.[10] However, eligible debtor states could refrain from opting into Article 8 altogether if they believe the mechanism could hinder their access to capital markets or raise their cost of capital in the future, as more fully explored below.

In some cases, the proposed law would operate both prospectively and retroactively.[11] Specifically, within the Article 8 framework, debtor states are presented with two alternative remedies: Section 223 and Section 230.

A. Section 223

Section 223 allows debtor states to restructure their liabilities through a collective voting mechanism. The debtor initiates Section 223 proceedings by filing a petition for relief with the state of New York.[12] The debtor must certify, among other things, that its debt is unsustainable, it has enacted any national or subnational law required to comply with Article 8, and that it is cooperating with the IMF to devise a path back to sustainability.[13] This self-certification method varies from the existing method, in which the IMF determines debt sustainability.

The governor of New York then appoints an independent monitor in consultation with the US Treasury Department to oversee the Section 223 process and facilitate a fair and effective agreement between the parties.[14] While the scope of the monitor's powers is not entirely clear, they are notably different from those of a bankruptcy court, and seem to be more akin to those of an "honest broker." The monitor can, however, evaluate petitions and dismiss them for a lack of good faith.[15] Furthermore, the selection of the independent monitor must be acceptable to both the sovereign and the majority of the sovereign's New York claimholders.[16]

Similar to the practice of debtor-in-possession financing in bankruptcy, and subject to certain conditions, the debtor may access new money during the restructuring.[17] Eventually, the debtor proposes a debt restructuring plan, which must classify claims and provide treatment for each class.[18] Article 8 specifies how claims can be categorized, notably (i) claims of governmental or multilateral entities must each be classed separately, and (ii) claims governed by New York law (or a jurisdiction that enacted a statute similar to Article 8) cannot be grouped with other claims.[19] Creditors may not submit competing plans.[20] The debtor's plan may cure or waive defaults, extend maturity dates, modify interest rates or principal amounts owed, and cancel or modify prepetition liens.[21]

Unlike in bankruptcy, the plan is not subject to court approval. Instead, to become effective, the plan must be approved by every class of claims, at which point claims are discharged except as provided therein.[22] The plan need not, however, be 100% consensual, so long as each class meets intra-class voting thresholds similar to those used in the US Bankruptcy Code. Specifically, a class is deemed to accept if two-thirds in amount and more than one-half in number of the claims of the class have voted in favor of the plan.[23] In this way, Section 223 addresses the holdout problem currently stymying the consensual restructuring of sovereign debt.

B. Section 230

Alternatively, debtor states participating in certain existing "international initiatives"[24] may opt for Section 230. These initiatives usually involve cooperation between multilateral institutions and sovereign bilateral lenders to provide debt relief to financially distressed states. Section 230 aims to ensure that private sector creditors contribute to debt relief as well.

To achieve that goal, Section 230 caps creditor recoveries by reference to what the US federal government would receive if it were a creditor under the relevant international initiative.[25] Section 230 also imposes equitable burden-sharing among creditors without regard for their official, private, or hybrid status, and mandates inter-creditor disclosure standards.[26] However, instead of going through a plan process, like in Section 223, the debtor state triggers Section 230 by providing notice to its creditors and the state of New York.[27]

Importantly, the amount that the US federal government would receive if it were a creditor is not easily computable and may be subject to gamesmanship. And Section 230 seems to ignore the relative seniority of claims and whether they are secured or not. It would seem that guardrails would need to be put in place so that creditors could view restructuring under Section 230 as a viable option.

Provided that the debtor is eligible for Section 230 (*i.e.*, it participates in an international initiative), the debtor has flexibility to choose between Section 223 and Section 230.[28] The debtor state may change its choice at any time before a Section 223 plan becomes effective, but only once.[29]

III. Implications of the Sovereign Debt Stability Act

The Sovereign Debt Stability Act proposes potentially valuable tools for governmental restructuring. Section 223 addresses a gap in existing debt documentation—mostly outside the bond context—lacking collective voting mechanisms. The qualified majority threshold under Section 223 is lower than that of certain existing collective action clauses, and thus more advantageous to sovereign states relative to the status quo in the bond context as well.[30] Additionally, although the practical implementation of Section 230 remains uncertain, it may significantly limit creditor recoveries.

Considering these seemingly debtor-friendly features, time will tell whether the statute, were it to be enacted, would deter lenders from participating in sovereign debt issuances governed by New York law.

On the other hand, however, the bill falls short in addressing key challenges associated with public debt restructuring. Critically, Article 8 would not apply to debt governed by laws other than that of New York, which constitutes the majority of sovereign indebtedness. While, as explained above, the enactment of similar statutes in other jurisdictions could expand the reach of Article 8, no such legislative initiatives outside New York have been reported to date.

Moreover, Article 8 does not provide for a stay of litigation—like the automatic stay in bankruptcy—failing to address the risk of creditor actions disturbing the debtor's restructuring efforts. In fact, Article 8 may inadvertently escalate the risk of litigation by failing to guarantee certain rights of potentially implicated creditors. Specifically, the statute could incentivize creditors to enforce their prepetition claims before those claims are collectively restructured under Section 223 or unilaterally capped under Section 230.

More specifically, while Article 8 contemplates broad debtor powers, such as the modification of principal amounts and the cancellation of prepetition liens, it does not afford dissenting creditors a minimum standard of treatment other than the promise of intra-class equality in Section 223 plans.[31] By contrast, in US municipal bankruptcy—which also deals with public sector debtors—creditors get the benefit of the *best-interests-test*, which operates as a "floor requiring a reasonable effort at payment of creditors by the municipal debtor."[32] These shortcomings are especially concerning with respect to secured creditors, which hold property interests in the collateral securing their claims that are typically safeguarded even in bankruptcy. Given that the bill implicates debt with a connection to New York, the US Constitution and the protections granted therein would still be applicable.

Therefore, failure to observe constitutional rights, particularly where Article 8 operates retroactively, could open the statute to legal challenges. Specifically, secured creditors could argue the impairment of their collateral amounts to taking without reasonable compensation, in contravention of the Takings Clause.[33] Creditors could also arguethe retroactive modification and discharge of their prepetition debt documents violates the Contracts Clause, which forbids US states—such as New York—from adopting laws impairing contractual obligations.[34] And creditors could assert the federal Bankruptcy Code operates to preempt the entire field of bankruptcy, preventing New York from passing legislation like Article 8.[35] Future drafts of the Act would likely need to account for these constitutional considerations.[36]

Aside from these potential constitutional deficiencies, Article 8 may increase financing costs for the very countries it aims to help by making sovereign debt contracts harder to enforce. For example, Article 8 could create uncertainty over these contracts' enforceability, leading to extensive litigation to resolve perceived ambiguities and drafting issues. In turn, this could drive the choice of governing law for sovereign debt contracts to other jurisdictions more likely to enforce contractual rights as written.

As global public debt levels continue to rise, New York's efforts to facilitate sovereign debt restructuring represent a significant development. While this specific bill may not pass before the end of the current legislative session in June 2024, we have no doubt that New York and potentially other jurisdictions will continue considering holistic legislative solutions that can streamline the complex process of sovereign restructuring. With the prospect of change in the sovereign debt restructuring space,[37] it is crucial for both sovereign borrowers and creditors to stay informed.

[1] *See* New York Senate Bill S5542A and New York Assembly Bill A2970A.

[2] International Monetary Fund, *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors – Recent Developments, Challenges, and Reform Options* (Oct. 1, 2020), https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/09/30/The-International-Architecture-for-Resolving -Sovereign-Debt-Involving-Private-Sector-49796 at 22 n.27.

[3] PROMESA stands for the Puerto Rico Oversight, Management, and Economic Stability Act.

[4] Many of Puerto Rico's instrumentalities have likewise successfully emerged from bankruptcy in recent years, including the Highway and Transportation Authority, the Employee Retirement System, the Puerto Rico Sales Tax Financing Corporation, and the Public Buildings Authority.

[5] Enacting federal legislation enabling US states to file for bankruptcy is not without challenges and would require, among other things, dealing with complex issues of federalism, a topic better left for a different article. *See* US Constitution, Amendment X.

[6] The New York State Legislature had previously introduced similar initiatives, including Assembly Bill A5290/Senate Bill S5623, Assembly Bill A2102A/Senate Bill S5542, and Assembly Bill A2970/Senate Bill S4747 in 2023, and the Sovereign Debt Stability Act must be seen as part of a larger effort by certain New York lawmakers to facilitate sovereign debt restructuring. In fact, as recently as May 20, 2024, Senator Liz Krueger and Assemblymember Jessica González-Rojas announced their intention to introduce a revised version of Assembly Bill A5290/Senate Bill S5623, which would seek to protect sovereign states from certain collection actions, as well as lower the statutory rate for pre-judgment interest-on-interest claims against sovereigns. *See* Liz Krueger, *Legislators Announce Updates to Champerty Bill* (May 20, 2024), https://www.nysenate.gov/newsroom/press-releases/2024/liz-krueger/legislators-announce-updates-champerty-bill.

[7] Article 8 § 221.4; considering the "subnational unit" language referenced above, whether US states could qualify as Article 8 debtor states remains an open question. *Id*.

[8] Article 8 § 221.2.

[9] Article 8 § 221.2.

[10] *See* Article 8 § 223.3.

[11] Article 8 § 231.1.

[12] Article 8 § 223.1.

[13] Article 8 § 223.2.

[14] Article 8 § 221.5.

[15] Article 8 § 223.3.

[16] Article 8 § 221.5.

[17] Article 8 § 227.

[18] Article 8 § 226.3.

[19] Article 8 § 226.6.

[20] Article 8 § 226.2.

[21] Article 8 § 226.3.

[22] Article 8 § 226.4.

[23] Article 8 § 226.5.

[24] Defined as “any mechanism, framework, or initiative in which the United States government and other sovereign states have engaged with international financial institutions and official and commercial creditors to advance the implementation and improvement of prompt and effective debt relief among eligible states,” including the Heavily Indebted Poor Countries Initiative, the Debt Service Suspension Initiative, and the Common Framework. Article 8 § 221.6.

[25] Article 8 § 230.3.

[26] Article 8 §§ 221.9, 230.1–230.2.

[27] Article 8 § 222.1.

[28] Article 8 § 222.1.

[29] Article 8 § 222.2.

[30] To the extent existing collective action clauses are inconsistent with Section 223, they are purportedly overridden. *See* Article 8 § 231.

[31] Article 8 § 226.3.

[32] *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999).

[33] US Constitution, Amendment XIV § 1; *see also* New York Constitution, Article I § 7.

[34] US Constitution, Article I § 10.

[35] *Cf. Puerto Rico v. Franklin Cal. Tax-Free Tr*., 579 U.S. 115, 139 (2016) (holding the Bankruptcy Code explicitly preempted Puerto Rico territorial statute enabling Puerto Rico’s public utility corporations to restructure their debt).

[36] Affected creditors of certain foreign nationalities could also potentially seek redress under international investment treaties, which usually provide qualifying investors with protections against expropriation without compensation (similarly to the Takings Clauses) and against unfair and inequitable treatment (such as the retroactive effect of legislation). Notably, in 2016, a group of 50,000 Italian bondholders utilized a bilateral investment treaty to secure a $1.35 billion payout from

Argentina in connection with the latter's 2001 default.

[37] Another evolving issue in the field, the possibility of a litigation stay being granted outside bankruptcy in favor of a distressed debtor state, is illustrated by the case of *Hamilton Rsrv. Bank Ltd. v. Democratic Socialist Republic of Sri Lanka*, No. 22cv5199 (DLC), 2023 BL 398649 (S.D.N.Y. Nov. 1, 2023) (staying litigation brought against Sri Lanka for defaulting on certain bond obligations); *see also Hamilton Rsrv. Bank Ltd. v. Democratic Socialist Republic of Sri Lanka*, No. 22-cv-5199 (DLC), 2024 BL 138259 (S.D.N.Y. Apr. 23, 2024) (extending the stay).

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