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How New York State Lawmakers Can Help Address Debt Crises in the Global South

By Martín Guzmán and Joseph E. Stiglitz

I. CONTEXT

Since the Bretton Woods system ended in the early 1970s, a period characterized by low capital mobility across countries because of capital account regulations, capital markets have globalized, leading to significant growth in international lending. The frequency of sovereign debt crises has increased since then.[1] Today, the scale of the debt troubles in the developing world represents a massive development crisis for the southern hemisphere. According to the United Nations, 3.3 billion people live in countries that spend more on debt service than on health or education.[2] An urgent solution is needed, entailing changes to legislation in the major jurisdictions for sovereign debt issuance.

Since the Bretton Woods system of fixed exchange rates was abandoned, several emerging markets have been able to develop domestic capital markets and borrow under domestic law in domestic currency. But a significant portion of developing nations' borrowing still occurs under foreign law using foreign currency. During the last five decades, there have been two big waves of growth of international private financing to sovereigns: The first occurred during the period that followed the Organization of Petroleum Exporting Countries (OPEC) shock in the 1970s, and the second during the period that followed the fall of Lehman Brothers in 2008. Both periods were marked by a massive increase in global liquidity. This burst of liquidity led to a search for yields from advanced countries' investors, which they found in less-advanced economies that issue sovereign debt at higher yields—

but with higher risks. Whereas in the first of those waves the main type of financing was bank loans, the post-2008 era was marked by increases in bonded debt.[3] New York State is the most important jurisdiction for developing nations' international borrowing: Because a large share of the international financial sector is based in New York, about 50 percent of global sovereign bonds are issued under New York State law.[4] New York State (NYS) law is therefore a major determinant of the stability of international lending markets, as it shapes the structure of incentives for international lending and borrowing decisions — and for debt restructurings when they are needed.

All countries have courts, often specialized bankruptcy courts, to oversee debt resolutions domestically. However, there is no legal framework for resolving situations of unsustainable sovereign debts — nothing analogous to the bankruptcy laws for corporations, municipalities, and, now, since the enactment in 2016 of PROMESA (the Puerto Rico Oversight, Management, and Economic Stability Act), American territories, or international courts to oversee sovereign debt restructurings. The resolution of sovereign debt problems is far more difficult than that of corporate debt problems, because there are a host of implicit creditors who hold the debt, such as retirees under social security systems, whose rights have to be recognized as the country assesses how much it can pay to bond-creditors. And resolving international debt problems is more difficult than resolving domestic debt problems, because there may be a conflict of laws, with different claimants having claims governed by different laws (as when a country issues bonds under both its laws and New York State law). Thus, it becomes the responsibility of states, like New York, to create a debt framework that works as well as possible. Current New York State law is deficient in several crucial ways. However, as we shall see, some current flaws can be easily remedied.

The lack of an international framework for sovereign debt resolution is a missing piece of the multilateral economic architecture that was built after World War II. The absence of such a framework means that when a sovereign nation faces a debt crisis, it has to negotiate a restructuring of the contracts with the creditors that hold them, without an arbiter to ensure that the resulting restructuring is fair or efficient, and without a mechanism to expedite the process in the face of intra-creditor squabbles. The result is a pattern of debt restructurings that can be characterized as "too little and too late." In the absence of a sustainable deal, the sovereign debtor can fall into a spiral of uncertainty that depresses aggregate demand and leads to political and social instability. A distressed sovereign debtor can also be exposed to years of litigation from bondholders — much of which is based in New York State, because of its significance in sovereign debt issuances.

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More specifically, NYS legislation covering sovereign debt and what happens when a sovereign debtor fails to meet its obligations is a major determinant of the incentives of the different stakeholders that

are part of any needed debt operation for contracts issued under NYS jurisdiction. Debt restructurings can take multiple forms, such as debt principal and interest reductions or maturity extensions, and entail many issues, such as comparability of treatment of different classes of creditors.

Deficiencies in certain key provisions of NYS law related to sovereign debt have long drawn attention. But the current global situation creates an urgency for reform: Two recent massive external shocks to the global economy, the COVID-19 pandemic and the war in Ukraine, had considerable effects on low-income and lower-middle-income countries and on some emerging economies. Almost everywhere, debt increased along with increased Keynesian expenditures to sustain the economy and to cover soaring food and energy bills, and along with reduced revenues resulting from economic downturns. The significant increases in interest rates as central banks responded to post-pandemic inflation enormously increased the cost of servicing this debt. As a result, the burden of interest payments in the national budgets of developing nations has increased significantly. A higher interest burden typically results in budget cuts being made in investments that are essential for economic development, such as education, health, social services, science, and public infrastructure. According to UN Trade and Development (UNCTAD), in 2023, 54 developing countries had net interest payments that exceeded 10 percent of their tax revenues.[5]

Where, one might ask, do developing countries with such debt burdens get the foreign exchange they need to service the debt? Data shows that there are simultaneous sizable transfers from international financial institutions (IFIs) such as the International Monetary Fund (IMF), the World Bank, or the regional development banks to low-income and lower-middle-income countries (LLMICs), and even more sizable transfers from those economies to their private creditors.[6] LLMICs are thus using funds from IFIs (essentially, money from global taxpayers) to service their debts with private creditors—a form of bailout that implies that while they are not defaulting on their debts, they are defaulting on economic development.

The G20 has recognized that neither a debt crisis nor an IFI bailout is acceptable, so it created the Common Framework for Debt Treatments in 2021, following which the IMF created the Global Sovereign Debt Roundtable in 2023; in 2024, the US Treasury went so far as to recognize the underlying problems with global debt.[7]

Unresolved debt crises prevent crucial action on climate change that has global impact.[8] There is moral outrage, too, as creditors are paid usurious interest rates while children die from hunger or lack of healthcare, and millions suffer.

Unresolved debt crises that create economic depressions do not only give rise to out-migration of people from indebted countries, including to New York. They also lower imports for the affected countries, which means lower exports for their trade partners, including the US, harming employment opportunities both in the debtor country and in the creditor jurisdictions that trade with the distressed debtor. Besides, these crises prevent crucial action on climate change that has global

impact.[8] There is moral outrage, too, as creditors are paid usurious interest rates while children die from hunger or lack of healthcare, and millions suffer. It is thus unsurprising that labor unions, civil society organizations, and religious communities in New York have gotten together over the past couple of years to advocate for a NYS legal system more suitable to the resolution of the sovereign debt and development crises of developing nations.

This report analyzes the need for reforms in the NYS legislation on sovereign debt and offers recommendations to New York lawmakers.

II. OBJECTIVES

When a nation's sovereign debt becomes unsustainable, a restructuring that restores sustainability is in the best interest of both the debtor country and its creditors as a whole. Unresolved debt crises lead to underutilization of resources, reducing the size of the pie to be distributed among all stakeholders. However, some major distributional conflicts — both debtor-creditor and inter-creditor — affect restructuring processes.

A proper framework for debt policies would lead to incentives that seek greater ex ante efficiency (that is, at the time of lending) and ex post efficiency (that is, at the time of restructuring). Such a system would foster due diligence before lending; monitoring afterward; and sustainable, equitable, efficient, and timely debt deals when a situation arises that requires a restructuring. Overall efficiency means that there is not the kind of contractionary economic policies often associated with debt crises and their resolution, which result in a waste of productive resources; ex post ency requires that debt restructurings be sustainable, i.e., that they do not result in the necessity of another debt restructuring a short while later — note that more than half of debt restructurings since the 1970s have been followed by another within five years.[9] And when a restructuring is needed, it should happen quickly, as delay can be very costly. To achieve the last goal, the system must discourage each creditor from (i) refusing to participate in negotiations, letting others provide debt relief in the hope that they will provide enough relief for their bonds to be fully repaid, or at least, in the hope of getting better treatment (referred to as "free riding"); (ii) delaying the achievement of a sustainable deal, in the hope that cost of delay for others will be sufficiently great for them to step up and provide the necessary debt relief. Creditors may also hope there will be external support, the effect of which is often simply to kick the can down the road, as frequently happens with bailouts financed by IFIs that leave the country with a legacy of higher debt with multilateral creditors. Those inter-creditor fights impose high costs on the debtor, lead to a loss of overall efficiency, and are one of the reasons that debt resolution cannot be left "to the market." Instead,

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there must be principles and rules, akin to (but still different from—recognizing that public debtors are different from private debtors) those that are invoked in debt resolutions within countries for private creditors.[10] [11] [12]

III. MISALIGNED INCENTIVES

Over the last 45 years, since sovereign debt crises have increased in frequency following the end of the Bretton Woods system, sovereign debt restructurings have suffered from the syndrome of too little (not deep enough) restructuring, coming too late.[13] Incentives are critical in explaining this syndrome. And some of those incentives have to do with current NYS law.

There are three main problems with current NYS legislation for sovereign debt.

(I) COMPENSATION FOR SECURITIES IN DEFAULT THAT INCENTIVIZES DELAYS IN RESTRUCTURINGS

The current prejudgment compensatory rate for debts in default (that is, the rate paid during the period between default and resolution) issued under New York State law is 9 percent, a rate that was set in 1981 when the annual inflation rate in the US was 8.9 percent.[14] That means that when a sovereign defaults on principal payments on its bonds, the value of the debt owed grows at a 9 percent rate until there is a judgment. This is clearly a flaw in the law, as such value was set in an inflationary environment with high interest rates that was markedly different from the current one. This provision of the law incentivizes noncooperation in sovereign debt restructurings, as it increases the connection between returns and delays: The bondholder gets a higher return by delaying (if the bondholder gets paid) than would be obtained on any other investment, and even if there is some downside risk associated with delay, the potential upside more than compensates.

(II) INCENTIVES FOR LITIGATION FOLLOWING SOVEREIGN DEFAULTS

Until 2004, NYS legislation included a stronger version of the law that prohibits the purchase of debt in default with the intent of suing the issuer, referred to as Champerty.[15] So-called vulture funds[16] purchase debts in distress at a deep discount, a fraction of the face value, with the purpose of avoiding debt negotiations, in order to litigate against the country that suffered the crisis and demand full payment of the face value of the debt. Simply put, these vulture funds profit from the business practices that Champerty restricted.

In 2004, New York State amended Champerty by passing Assembly Bill 7244-C, which eliminated the prohibition of debt purchases above $500,000. Vulture funds lobbied for Champerty to be changed.[17] Lawmakers provided no justification other than arguing that Champerty was an archaic law. After lawmakers repealed Champerty, vulture funds proliferated.

These vulture funds are the classic free riders discussed earlier, and over the last few decades they have impeded countries from attaining sustainable debt resolutions. The vulture funds' strategy relies on the expectation that if other creditors settled with deep cuts, the country would then be able to pay them the full amount, or closer to the full amount than the others received. Of course, other creditors, knowing this, may be loath to settle: Each creditor wants to be treated at least as well as the others. The profitability of such behavior creates a moral hazard problem, as it becomes more tempting for other creditors to follow the lead of a litigant vulture fund. The implication is a severe inefficiency: the resulting delay in debt resolution is very costly to the debtor country; it underperforms. But the vultures can also hurt others. Because of the underperformance, the overall debt payment capacity is negatively affected. Good faith creditors are thus negatively affected by the repeal of Champerty for large purchases. That's why the repeal was pushed just by the vultures, and today, there are good faith creditors that support a restoration of Champerty.

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Vulture funds' behavior also entails an inefficient utilization of the New York taxpayers–funded court system, which may end up devoting countless hours to deal with a conflict between a number of vulture creditors and a sovereign nation (the most extreme case was Argentina's dispute with the hedge fund Elliott Management in the New York courts, lasting more than a decade.[18]

Even before New York's legislature amended Champerty, the courts' interpretation in the case of Peru had debilitated it. In 1996, Elliott Management bought Peru's debt in default at roughly 50 percent of its face value.[19] Then Elliott sued for the full value of the debt. The New York Southern District Court ruled that Champerty applied. Elliott appealed. In the appeal, the Second Circuit decided in favor of Elliott. The court ruled that Champerty did not apply because Elliott had bought the debt to get repaid in full or otherwise to litigate. This novel interpretation of the law does not fit with the underlying logic of finance, where it is well understood that higher-risk investments come with higher returns because of said risk—in the case of Peru, creditors' expectation of getting a defaulted bond that traded at half the face value paid in full was unreasonable. The Second Circuit's decision would prove to be an important precedent for the wave of litigation against sovereign nations in debt distress from then on.

The main progress made over the past decade in tackling vulture funds was the adoption, in the issuance of bonds, of new collective action clauses (CACs) that facilitate the aggregation of bondholders in sovereign debt restructurings, endorsed by the International Capital Markets Association in 2014.[20] The new CACs had better ways of handling this problem, and were endorsed by the International Capital Market Association in 2014. Under these provisions, if enough bondholders agree to a

restructuring, then the holdouts have to accept the terms of the restructuring. (Complications arise from the existence of many classes of bondholders. How the voices of these different groups, with sometimes different interests, are to be weighted is crucial.) Bonds issued later than that date typically have these provisions. So far, there have been two restructurings involving bonds with the new enhanced CACs, Argentina and Ecuador, both in 2020.[21] Although the new CACs improve the efficiency of restructuring processes, they do not address the myriad problems that arise in the resolution of unsustainable debt burdens (for instance, they cover bonds but not other claims, and are insufficient to lead to an agreement on the level of debt that is sustainable). Thus, in these two cases, while the problem of vultures did not seem to arise, there were delays in the resolutions that could have been avoided under better frameworks, and the size of the debt relief was perceived by many as likely not to remain sustainable (it is yet to be determined whether those countries will be able to sustain the debt payments agreed to in the restructurings). In any case, a scant two observations is far from sufficient to conclude that CACs eliminate the problem of holdouts in restructurings.

(III) INCENTIVES FOR BONDHOLDERS' FREE RIDING ON OFFICIAL CREDITORS

Another problem is private creditors' incentives to wait until official creditors have restructured their debts to get a better deal. The private creditors' implicit strategy is that the financing from IFIs that is supposed to play a development and macro-stabilizing role can instead be used for amortizing debts with the private sector. This approach turns out to be especially important when a country suffering an economic crisis has no access to international credit markets, as is currently the case for many LLMICs.[22] In such situations, there is, in effect, a (typically partial) bailout of the private sector by the public. This bailout not only distorts behavior after a crisis occurs (as the private sector delays its restructuring until after the public sector has done its restructuring), but ex ante. That is, bad loans are made in anticipation of such a bailout. The current system provides insufficient protection to global taxpayers, including New York taxpayers, from the possibility that their money will end up being used to bail out private creditors, with official creditors taking a bigger "haircut" (in terms of debt reduction) than private creditors.

IV. RECOMMENDATIONS

Over the past three years, there has been a surge of initiatives for reforms, and multiple different bills have been pushed in the New York legislature.[23] Those reforms have certain elements in common. Our view is that the reforms should address the three key problems laid out above. More specifically, we recommend:

- An elimination of the $500,000 threshold in the Champerty law. The spirit of the reformed legislation must be to tackle the problem of vulture funds. This approach is different from restricting litigation for all creditors, which Champerty does not do. In fact, two already introduced bills, A5290 and SB5623, have been carefully tailored to limit the practices of purchasers of distressed debt that have the express intention of litigation.[24]

- A reduction of the pre-judgment compensatory rate from 9 percent to the one-year US Treasury yield, as proposed in bills A5290 and SB5623. This would simply correct a flaw in the law that set the compensatory pre-judgment rate at a high fixed level that should now be obsolete because circumstances have changed.

The 2025–2026 legislative session will begin in January 2025, and lawmakers are expected to reintroduce bills related to sovereign debt. A bill with the two elements outlined above would improve efficiency in sovereign debt markets. A third element would improve equity.

- The enactment of legislation to ensure equitable treatment between private and official creditors in sovereign debt restructurings, especially for LLMICs, which are the ones that disproportionately receive financing from public creditors. (Emerging markets get a disproportionate fraction of financing from the private sector.)

Current arrangements are insufficient for ensuring comparability of treatment. In particular, public-sector comparability is a standard that cannot be guaranteed by contract-based solutions relying on a supermajority of creditors' agreements (those embracing CACs). Moreover, provisions requiring comparability of treatment would encourage earlier debt restructurings.

V. CONCLUSION

The problems with NYS legislation on sovereign debt law go back more than 40 years. The deficiencies were less visible in an environment dominated by bank loans, as existed in the 1980s, or one of more stability in developing nations. Today's reality urgently calls for change.

The work of various civil society organizations and some legislators over the past two years has been tremendously valuable in creating a more widespread understanding of the need for reforms — and if a solution is achieved, it will be the result of all their efforts. Academics have widely discussed these issues, more recently including in meetings held at Columbia University School of International and Public Affairs in November 2023, and at the World Bank during the IMF/World Bank Group 2024 Annual Meetings. Every reform to legislation for sovereign debt is associated with a change in the bargaining power of the various stakeholders; this being the case, it is virtually impossible to achieve full consensus. It should be obvious that the vulture funds would oppose any legislation that clips their wings. But at this point, there seems to be a consensus among experts that the recommendations laid out in this paper would improve the functioning of sovereign debt markets.

In 2025, NYS lawmakers will have the opportunity to pass legislation that would address a significant driver of global inequality. There is no justification for NYS law granting 9 percent annual returns to holders of defaulted bonds. In a world where potential solutions to enormous challenges such as poverty and climate change are often described as complicated if not unrealistic, the reforms described in this report provide a concrete course of action for making global finance more equitable and efficient — which in turn would help the lives of millions of people in developing countries and emerging markets.

ENDNOTES

1 Barry Eichengreen, "Bretton Woods After 50," *Review of Political Economy* 33, no. 4 (2021): 552–569.

2 Edith M. Lederer, "3.3 Billion People Live in Countries That Spend More on Debt Interest Than Education, UN Says," Associated Press, July 12, 2023.

3 Martín Guzmán, Yanne Horas, Anahí Wiedenbrüg, and Maia Colodenco, "The Relationship between Sovereign Debt and Politics," *Social Research: An International Quarterly* 91, no. 3 (2024): 913-938.

4 International Monetary Fund, *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, and Reform Options* 22, no. 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.

5 UNCTAD, *A World of Debt* (2024), https://unctad.org/publication/world-of-debt.

6 Ishac Diwan, Martín Guzmán, Martin Kessler, Vera Songwe, and Joseph E. Stiglitz, *An Updated Bridge Proposal: Towards a Solution to the Current Sovereign Debt Crises and to Restore Growth*, no. 2405 (CEPREMAP, 2024).

7 Jay Shambaugh, *The U.S. Vision for Global Debt and Development Finance*, April 11, 2024.

8 Kevin Gallagher, "Acting in Parallel on Debt and Development before It Is Too Costly and Too Late," in *Managing U.S.-China Tensions over the Global Economic Order*, Center for Strategic and International Studies, 2024.

9 Martín Guzmán and Joseph E. Stiglitz, "The Practice of Sovereign Debt Sustainability Analysis" (Jubilee USA Network: Friedrich Ebert Stiftung NYC Office, 2024). There may of course be differences of "views" between the debtor and its creditors, possibly based on competing interests, on what *sustainability* means.

10 Lawrence M. Ausubel, Peter Cramton, and Raymond J. Deneckere, "Bargaining with Incomplete Information," *Handbook of Game Theory with Economic Applications* 3 (2002): 1897–1945. Such delay is a common feature in bargaining equilibrium in the presence of asymmetric information.

11 Joseph Stiglitz, "Sovereign Debt: Notes on Theoretical Frameworks and Policy Analyses," in *Overcoming Developing Country Debt Crises*, ed. B. Herman, J.A. Ocampo, and S. Spiegel (Oxford University Press, 2010), 35–69.

12 In some cases, provisions of the legal framework can be thought of as "completing the contract," that is, putting in place provisions that might have been included in a contract that had more extensive contingency provisions. Sovereign debts have some complexities not present in private debt, associated with "implicit" obligations, for instance, associated with public obligations for health, education, and retirees.

13 Martín Guzmán, José Antonio Ocampo, and Joseph E. Stiglitz, eds., *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press, 2016).

14 For a more comprehensive analysis, see: Jonathan I. Blackman and Rahul Mukhi, "The Evolution of Modern Sovereign Debt Litigation: Vultures, Alter Egos, and Other Legal Fauna," *Law and Contemporary Problems* 73, no. 4 (2010): 47–61.

15 Sean Kelly, "Financial Regulation—The Ancient Doctrine of Champerty and a First for the New York Court of Appeals," *Suffolk Transnational Law Review* 40 (2017): 395.

16 Julian Schumacher , Christoph Trebesch, and Henrik Enderlein. "What Explains Sovereign Debt Litigation?" *The Journal of Law and Economics* 58, no. 3 (2015): 585–623.

17 Martín Guzmán, "An Analysis of Argentina's 2001 Default Resolution," *Comparative Economic Studies* 62, no. 4 (2020): 701–738.

18 Martín Guzmán, José Antonio Ocampo, and Joseph E. Stiglitz, eds., *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises* (Columbia University Press, 2016).

19 Manuel Monteagudo, "Comments About the Experience of Peru in Sovereign Debt Litigation," *Banking & Finance Law Review* 23, no. 2 (2008): 293.

20 Deborah Zandstra, "New Aggregated Collective Action Clauses and Evolution in the Restructuring of Sovereign Debt Securities," *Capital Markets Law Journal* 12, no. 2 (2017): 180–203.

21 Martín Guzmán, co-author of this report, served as minister of economy of the Republic of Argentina from December 2019 to July 2022.

22 Ishac Diwan, Martín Guzmán, Martin Kessler, Vera Songwe, and Joseph E. Stiglitz, *An Updated Bridge Proposal: Towards a Solution to the Current Sovereign Debt Crises and to Restore Growth*, no. 2405 (CEPREMAP, 2024).

23 Gregory Makoff, "Advice for New York State and International Policymakers Regarding Sovereign Debt Reforms at the State Level" (working paper, 2024).

24 New York State Senate, "A5290 (2023–2024 Legislative Session): Bill Text," last modified December 19, 2023, https://www.nysenate.gov/legislation/bills/2023/A5290/amendment/A.

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