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SUPPORT MEMORANDUM

Ref: S.1477 Krueger / A.643-A González-Rojas

By Martin Guzman[i] and Joseph E. Stiglitz[ii]

A debt crisis is endangering development around the world, increasing the risk of defaults in the coming years, especially in low and lower-middle income countries. When countries suffer debt crises, prolonged and insufficient debt restructurings delay economic recovery and stunt funding for priorities like healthcare, education, and mitigating impacts of the climate crisis. This dangerous situation calls for urgent attention to the inefficiencies in the sovereign debt restructuring landscape.

One such inefficiency, which has gained prominence since the 1990s, is the ability of so-called vulture funds to disrupt normal sovereign debt restructurings via pursuing litigation in the hopes of receiving preferential repayment vis-a-vis other creditors. This tactic has primarily been employed in New York and London courts as these jurisdictions account for the majority of sovereign bond governance. Efforts are underway in both jurisdictions to correct this.

Because New York State houses a large share of the international financial sector, over 50 percent of global sovereign bonds are issued under New York State law. Until 2004, New York law contained a stronger version of a provision, called champerty, which prevents the purchase of debt with the intent of suing the issuer. This served as a defense that countries could employ against vulture fund lawsuits. However, in 2004, the New York State legislature amended the champerty law, inserting a provision which removed debt purchases above $500,000 from the purview of the law. This revision followed lobbying on behalf of vulture funds and enabled their subsequent proliferation.

Aside from jeopardizing countries' economic recovery in the wake of default, the vulture fund strategy relies on the expectation that other creditors settle with deeper cuts in order to increase the amount countries can pay to the litigious funds. This results in a severe inefficiency in the restructuring process, harming not only debtors but other creditors as well. This is why, today, there are good faith creditors that support a restoration of the champerty defense.

The champerty bill (S1477 / A643-A) does not introduce new policy. Instead, it will correct deficiencies in current New York law, removing the $500,000 carveout loophole. In addition, it will lower New York's punitive prejudgement interest rate provision, which further incentivizes litigious behavior during restructurings. The current prejudgement interest rate issued under New York State law is 9 percent, which was set in 1981 during a period of high inflation and never lowered. Correcting this rate to the one-year treasury bill rate will reduce the incentive to draw out lawsuits for profit. Importantly for the mainstream market, the champerty bill excludes conventional and cooperative distressed debt investors, who retain their full enforcement rights.

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While the champerty bill corrects a crucial inefficiency in sovereign debt restructurings, more issues remain which need to be addressed in key jurisdictions, including New York. The champerty bill does not address issues arising from the growing share of non-bonded debt types, for which there is no private sector coordination mechanism. These liabilities, including arbitration awards and other investment treaties, will likely make up an increasing proportion of litigation in the coming years. Finally, the champerty bill does not address the incentive structure that enables private creditors to obtain deals which place them senior to official and multilateral creditors. Under this structure, funding from international financial institutions that should go towards development priorities may instead be utilized for amortizing private sector debts.

Despite these outstanding issues, passage of the champerty bill is a critical first step towards a more efficient restructuring framework. We welcome the passage of the champerty bill through the New York State Senate and respectfully urge the New York State Assembly to quickly follow suit.

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