Shrinking Pie

The ugly world for Venezuela's creditors.

By Steven T. Kargman

Major litigation risks facing both the Republic of Venezuela and its state-owned oil company PDVSA could considerably complicate and even potentially diminish the prospects for an orderly and successful restructuring.

The Venezuelan sovereign debt situation is unlike other recent prominent sovereign debt restructurings, since the sovereign debtor in question has assets outside of its own borders that could be subject to possible creditor attachment. As a practical matter, creditors in sovereign debt restructurings are often prevented from attaching many, if not most, of the properties of a sovereign outside the sovereign's own borders. Specifically, due to special immunities enjoyed by sovereigns, creditors cannot attach a sovereign's most obvious overseas property such as the sovereign's embassies and consulates. Moreover, as long as the sovereign is not engaged in what is considered "commercial activity" in the foreign jurisdiction, its overseas property is protected under the theory of so-called restrictive sovereign immunity (which is embodied, for example, in the U.S. Foreign Sovereign Immunities Act). But Venezuela has valuable assets outside of the country, including PDVSA's Citgo-related assets in the United States.

By contrast, during the sovereign debt restructuring following its 2001 default, the Republic of Argentina had few attachable assets outside the country. Despite the court judgments outstanding, holdout creditors then had limited options for collecting on their judgments given the scarcity of assets outside of Argentina that were not shielded by sovereign immunity. Except for certain hedge funds that pursued a long-running, aggressive, and costly litigation strategy, creditors were generally not able to collect on their judgments.

However, the existence of PDVSA assets and operations outside of Venezuela has already presented tempting targets for creditors of the Republic, particularly in view of the "alter ego" theory embraced by the U.S. Court of Appeals for the Third Circuit in the *Crystallex* litigation, which broadly allowed creditors who obtain judgments against the Republic to execute against the assets of PDVSA and/or its affiliates.

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Normally, though, creditors of a sovereign cannot attach the assets of a state-owned entity to satisfy a judgment against the sovereign as long as the state-owned entity is operating as an independent, separate entity (that is, the state-owned entity has its own legal personality). Yet the "alter ego" theory allows creditors of the sovereign to essentially disregard the separate corporate form of the state-owned entity (such as PDVSA) and thus the assets of the state-owned entity become subject to attachment by the creditors of the sovereign.

(In late September 2019, the U.S. Court of Appeals for the Third Circuit lifted a judicial stay that had been put in place preventing *Crystallex* from executing on its judgment and seizing the shares of Citgo's holding company, giving *Crystallex* the green light to proceed with its enforcement efforts, subject to any court challenges or appeals that might arise in the interim.)

RACE TO THE COURTHOUSE

A protracted delay in initiating a debt restructuring process for Venezuela in circumstances where some creditors have already pursued litigation could encourage other creditors to consider initiating their own legal actions. In this pre-restructuring period, creditors may not wish to be left out in the cold if other creditors have already begun to pursue or ultimately realize recoveries on their claims. This dynamic has the potential to set off the classic—but often dreaded—"race to the courthouse."

Such a race is not conducive to any orderly restructuring process at a later date, and that is why a stay or moratorium on creditor actions against a debtor is considered an indispensable feature of any well-designed insolvency law. Moreover, a race to the courthouse runs counter to the crucial principle in insolvency law of equality of treatment for similarly situated creditors, since it privileges certain creditors—those bringing lawsuits and making recoveries—at the expense of others who do not bring lawsuits and achieve recoveries on their unpaid debt.

Furthermore, there is a significant related risk that such creditors carve up the debtor's assets before an orderly restructuring can take place. Such a prospect could give rise to what is referred to in the insolvency literature as the "premature dismemberment" of the corpus or pool of assets that would be used to support any eventual out-of-court restructuring or in-court formal reorganization.

Significantly, this "premature dismemberment" dynamic could result in fewer resources of the debtor being available to support any eventual restructuring, thereby complicating efforts to reach a successful restructuring.

Ordinarily, in the commercial context, a moratorium or stay on creditor lawsuits comes into effect upon the commencement of an insolvency proceeding. However, neither PDVSA nor any of its affiliates (including its U.S.-based affiliates) have yet filed for insolvency either in Venezuela or the United States, and consequently are so far not thus entitled to the protection afforded by a stay or moratorium on creditor actions.

Pursuing litigation carries its own risks.

But while a sovereign can benefit from the theory of restrictive sovereign immunity and certain other special immunities that prevent attachment of a sovereign's assets, there is a major gap in the international financial architecture: Unlike for business enterprises, there is no existing insolvency law applicable to sovereigns and thus no stay or moratorium comes into effect when the sovereign becomes insolvent. Moreover, in sovereign debt offerings, sovereigns often waive sovereign immunity with respect to the commencement of legal actions against the sovereign.

RISKS OF PRE-RESTRUCTURING LITIGATION

Pursuing litigation carries its own risks that creditors would need to evaluate carefully. Litigation outcomes will ultimately be determined by courts and any other relevant tribunals, and can be difficult to predict. Furthermore, litigation (and even arbitration) can be a very lengthy and expensive process.

The availability of third-party litigation funding, which was apparently used in some of the *Crystallex*-related litigation, can potentially relieve some of the financial burden to creditors who are interested in pursuing litigation. Creditors utilizing third-party litigation funding, however, need to share recoveries with those providing the funding.

To the extent creditors of the Republic of Venezuela and/or PDVSA decide to use third-party litigation funding, the availability of such funding has the potential to turbocharge creditor litigation. Lack of adequate resources need not deter creditors.

By contrast, in earlier sovereign debt disputes (such as Argentina in 2001, 2005, and 2010), only those creditors with very deep pockets could afford to stay the course with the potentially costly, complex, and lengthy litigation process. With Argentina, certain hedge funds specializing in purchasing distressed debt at deeply discounted prices were not reluctant to pursue aggressive, years-long litigation in order to maximize their recoveries. In the end—after holdouts reached a settlement with the new Macri government in early 2016, more than fourteen years after the original default—some of those hedge funds were able to achieve outsized rates of return, in some cases amounting to several hundred percent.

For Venezuela, several external factors could make the litigation process much less straightforward and less predictable than would otherwise be the case.

INSOLVENCY LAW

The first external factor relates to insolvency law considerations. As noted, an insolvency filing by PDVSA and/or its affiliates could provide the relevant debtors the benefit of a moratorium or stay against creditor actions including lawsuits and enforcement actions, depending on where those insolvency proceedings were filed. Nonetheless, PDVSA insolvency proceedings would raise a number of complex, nuanced, and highly technical legal considerations. A full examination of all of the relevant insolvency law issues would be beyond the scope of this article, so we will simply highlight a few key issues.

One scenario is whether PDVSA could potentially file for insolvency in Venezuela under Venezuelan law. If it did so, would PDVSA as a debtor be the type of entity that would fall within the ambit of Venezuela's existing business insolvency framework, or would it need to have a special-purpose insolvency statute drafted to deal with its unique characteristics as an absolutely critical state-owned or public enterprise in Venezuela?

As in many emerging market jurisdictions, there might be practical issues as to whether the particular Venezuelan court and judge assigned a PDVSA insolvency filing would have the capacity and independence to handle such a large, complicated case.

Furthermore, if PDVSA filed for insolvency protection in Venezuela, there would be a related issue of whether it would seek protection in the United States for its U.S.-based affiliates under Chapter 15 of the U.S. Bankruptcy Code. Chapter 15 provides that U.S. bankruptcy courts can grant so-called recognition to foreign insolvency proceedings and furnish assistance in support of those proceedings, including providing relief to the foreign debtor such as a stay or moratorium against creditor actions in the United States.

However, in the event of a Chapter 15 filing, there might be questions as to whether the Venezuelan insolvency proceedings would be of the type that would comport with U.S. concepts of due process such that a U.S. bankruptcy court would feel comfortable granting recognition to the Venezuelan insolvency proceeding.

Apart from a PDVSA insolvency proceeding in Venezuela and/or an ancillary proceeding in the United States under Chapter 15, there is the possibility of an insolvency filing under U.S. insolvency law. Specifically, PDVSA's U.S.-based affiliates such as its main U.S. holding company, PDV Holding, might consider filing for reorganization under Chapter 11 of the U.S. Bankruptcy Code.

In sum, any creditor seeking to bring a lawsuit or enforce a judgment against PDVSA and its affiliates will need to consider the relevant insolvency law landscape in Venezuela, the United States, and any other applicable jurisdictions. Insolvency proceedings could trigger a stay or moratorium on creditor actions.

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SANCTIONS

A second external factor that creditors considering litigation need to assess is the potential impact of any existing and future sanctions imposed by the U.S. or other governments as they relate to the ability to realize against certain Venezuelan assets, particularly those of PDVSA and/or its affiliates (including U.S.-based affiliates).

The ability of sanctions to affect creditor interests can be seen in the situation surrounding the PDVSA 2020 bonds discussed in the Summer 2019 *TIE.* In July 2018, the Office of Foreign Assets Control within the U.S. Treasury gave relief to the holders of PDVSA 2020 bonds from the sanctions that were then in place against Venezuela by providing what is known as a "general license" in OFAC parlance. A general license—effectively an exception to sanctions—permitted the bondholders to foreclose on the pledge of CITGO Holding stock in their favor in the event of a payment default by PDVSA on the PDVSA 2020 bonds. Without that particular license issued by OFAC, the holders of the PDVSA 2020 bonds would have been prohibited from such an enforcement action by the sanctions against Venezuela.

Then on October 28, 2019, PDVSA faced a $913 million interest payment on its 2020 bonds. In the period leading up to that date, there was substantial uncertainty and doubt as to whether PDVSA (and particularly the alternate PDVSA board of directors consisting of individuals aligned with the so-called interim government led by National Assembly President Juan Guaidó) would have the available funds to make the scheduled payment. Since the PDVSA 2020 bonds are secured by a 50.1 percent interest in the shares of Citgo Holding Co., a failure to make the October payment could have led to a loss of control of Citgo to the holders of the PDVSA 2020 bonds.

With the October 28 payment date hanging over it like a sword of Damocles, the alternate PDVSA board and its

representatives sought relief from the U.S. Treasury. Just before the payment date, OFAC announced on October 24 that it had temporarily withdrawn the license given the PDVSA 2020 bondholders for a period of ninety days.

With the October 24 OFAC action, the U.S. government extended a critical short-term lifeline to the alternate PDVSA board and thus the Guaidó-led opposition forces. It was widely believed by observers that if the alternate board of PDVSA lost control of Citgo by virtue of defaulting on its scheduled payment, the so-called interim government would have been seriously hamstrung if and when it ultimately replaced the Maduro regime and assumed power in Venezuela. At present, Citgo is basically the only asset over which the Guaidó-led interim government has control. (Despite the existence of an alternate PDVSA board appointed by the interim government, the reality is that the Maduro regime retains effective control over the assets and operations of PDVSA in Venezuela itself.)

Thus, PDVSA and its alternate board were given a brief reprieve. Whether between now and the expiration of the ninety-day period in late January 2020 the PDVSA alternate board will get its hands on the resources to make the large required debt service payment, or whether the alternate board can reach some type of settlement with the bondholders, or whether it will get further relief or protection from the U.S. government, remains to be seen.

However, just as this issue of *TIE* was going to press, a new development arose that will reportedly give PDVSA until May 2020 to work something out, if possible, with the holders of the PDVSA 2020 bonds. Even before that, in late October, PDVSA's alternate board had filed a lawsuit challenging the validity of the PDVSA 2020 bonds and seeking to have the bonds declared null and void.

In this most recent development, it has been reported that PDVSA 2020 bondholders will essentially forbear until May 2020 from exercising their right to exercise their pledge on the Citgo Holding stock in the event of non-payment. This forbearance will reportedly remain in effect while the litigation process unfolds in the lawsuit challenging the validity of the PDVSA 2020 bonds—another reprieve.

In short, whatever U.S. sanctions are in place at the time could have a crucial bearing on what assets the creditors can and cannot attach.

Ever since the Trump administration first imposed sanctions against Venezuela in the summer of 2017, a complex sanctions regime has taken root. Creditors would need to carefully navigate their way through the thicket of sanctions that are in place at the relevant time. They would also need to have a firm grasp of any relief (such as so-called licenses) that has been granted under the sanctions and any guidance on the sanctions that has been issued by OFAC. As recent events surrounding the PDVSA 2020 bonds illustrate,

The various creditor constituencies could all end up vying for their own stakes in a shrinking economic pie.

a sanctions regime can be a moving target. Sanctions can be modified over time, licenses that were previously granted by OFAC can be withdrawn or temporarily suspended, and guidance that was issued by OFAC can change.

If creditors wish to make an exit from their Venezuelan debt, they will also have to consider any restrictions under the sanctions then in effect that might limit their ability to sell their debt to third parties. For example, early in 2019, U.S. sanctions imposed a trading ban on U.S. institutions from doing business in PDVSA and Republic securities with other U.S. entities. Thus, if U.S. holders of Venezuelan debt wanted to unwind their positions, they could only sell to non-U.S. buyers. (According to news reports over the last several months, certain bondholders and/or their representatives have been lobbying the U.S. Treasury to soften those particular sanctions.)

Creditors would also need to factor in the extent to which other governments have sanctions in place against Venezuela, PDVSA, and/or particular Venezuelan citizens.

EXECUTIVE ORDERS

A third external factor for creditors to consider is the possibility that a U.S. president will in the future issue an executive order that, broadly speaking, immunizes Venezuelan assets in the United States from attachment and other enforcement actions. This idea was proposed by Lee Buchheit and Mitu Gulati and draws on the precedent of an executive order issued by the George W. Bush administration as Iraq's debt was restructured in the early 2000s.

The Guaidó-led opposition has strongly advocated the adoption of such an executive order. In an interview in May with Reuters, Guaidó indicated that, in order to enhance Venezuela's economic recovery prospects after Maduro, a U.S. executive order would be necessary to protect Citgo from seizure by creditors. Furthermore, leading up to the recent October 28 payment date on the PDVSA bonds, the Guaidó-led forces called for the adoption of an executive order that would protect the Citgo assets from attachment and thus relieve the pressure on PDVSA's alternative board to make the payment.

However, there was pushback from bondholders on this proposal and the Trump administration instead temporarily suspended a license previously granted that allowed the PDVSA 2020 bondholders to enforce against Citgo-related collateral. The Trump administration issued a different type of executive order (EO 13884) on August 5, 2019, that froze Venezuelan government assets in the United States.

If the possibility of an executive order along the lines of the Buchheit-Gulati proposal were to be subject to public consideration and debate, there might well be significant resistance from U.S.-based creditors, particularly bondholders. Such a move might frustrate creditor efforts to make a recovery based on their ability to go after U.S.-based assets of Venezuela, in particular Citgo-related assets.

The issue has already emerged as a flash point between the Guaidó-led opposition and a committee of bondholders reported to be holding approximately $8 billion of Venezuelan debt. In a statement released in early July, the bondholder group strongly opposed the issuance of such an executive order.

Some might argue that Venezuela has already obtained the protection it would need for its U.S.-based assets through the August 5 executive order, and that a new executive order along the lines of the Buchheit-Gulati proposal discussed above would therefore no longer be necessary.

A U.S. president could in the future issue an executive order that, broadly speaking, immunizes Venezuelan assets in the United States from attachment.

However, if a regime more acceptable to the United States comes into power, then presumably the U.S. government would lift EO 13884, since those blocking sanctions are squarely aimed at the Maduro regime. At that point, however, the new Venezuelan government would still want protection for its U.S.-based assets and might therefore request or petition the U.S. executive branch to issue a new executive order along the lines of the Buchheit-Gulati proposal. Importantly, in the event that such a new executive order were to be issued, it would be aimed at benefiting the new post-Maduro Venezuelan government.

In sum, creditors considering initiating litigation and/or enforcement actions against the Republic and/or PDVSA will need to be mindful of executive orders and their specific contours.

EXTRAORDINARILY MESSY AND COMPLICATED

If and when the restructurings involving the Republic of Venezuela and PDVSA eventually take place, they promise to be more extraordinarily messy and complicated than most in recent years for several reasons.

First, the creditor bodies for both the Republic and PDVSA are incredibly diverse. This could make creditor coordination challenging, to say the least. The creditor bodies consist of a broad array of parties such as bondholders, bilateral creditors (including Russia and China), trade creditors/service providers, arbitration award holders, multilateral institutions, promissory note holders (including major international oil field service companies), and so-called “blocked payment” claimants (including, for example, foreign airlines that did not receive the foreign exchange owed to them by Venezuela).

Second, inter-creditor disputes between these constituencies, with their very different interests and agendas, could be intense. For instance, bondholders may have a laser-like focus on their potential recovery rates and the rate of return on their investments, while certain oil field service providers may want to preserve or re-establish a longer-term relationship with the Republic and/or PDVSA. There may be conflicts between creditors who adopt a transactional perspective and those who adopt a relationship-focused perspective.

Third, China and Russia, as the largest bilateral creditors of Venezuela, could play significant roles in any restructurings. With $20 billion and $5 billion respectively in debt holdings, China and Russia represent two of the biggest wild cards, even if at present their precise agendas appear somewhat opaque. China in particular is not a member of the Paris Club of bilateral creditors, so likely will not feel constrained by any of the group’s guiding restructuring “principles.”

Fourth, as discussed in the Spring 2019 *TIE,* a delay in initiating the restructuring processes could only make it more challenging. With such delay, there is the possibility of continued deterioration of the Venezuelan economy in general and the oil industry in particular, as well as the potential emergence of more creditor-initiated lawsuits, particularly if such lawsuits are successful and encourage other creditors to pursue litigation.

Creditors may be faced with the unwelcome prospect of diminished resources at the disposal of the Republic and/or PDVSA, making negotiations even more strained and contentious. The various creditor constituencies could all end up vying for their own stakes in a shrinking economic pie—in short, not a very attractive prospect at all. ◆