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Venezuela's Debt Crisis: Creditors' Options in a Disorderly Default

Investors in Venezuelan debt and other creditors should be prepared for an Argentina-style disorderly default. Creditors nonetheless have real options.

After months on the precipice of default, Venezuela's President Maduro has acknowledged that Venezuela and its state-owned oil company PDVSA are unable to pay their debts. With a series of missed coupon payments and the 30-day grace period expired, all three major ratings agencies now rate Venezuela and PDVSA as in default or selective default.

In some instances, a government in default may simply engage creditors to seek an agreed restructuring of the debt. Thus far, the first meeting in Caracas between Venezuela and its creditors failed to lead to any resolution. Even if Venezuela's creditors were inclined to renegotiate its debts, a number of prohibitive hurdles exist. First, Venezuela and some of its leaders are subject to U.S. sanctions prohibiting the issuance of new debt under certain circumstances. Second, a number of Venezuela's older sovereign bonds do not include Collective Action Clauses, meaning that a single holdout can enjoin payments on any restructured bonds unless the holdout's debt is paid in full. Even those bonds that do contain Collective Action Clauses have high thresholds before holdouts can be forced to restructure, and these thresholds will be difficult to reach. Investors in Venezuelan debt and other creditors should therefore be prepared for an Argentina-style disorderly default.

As this *Kirkland Alert* explains, creditors have real options. Within the bond instruments, Venezuela agreed to litigate claims based on its bonds before New York courts, and provided a broad waiver of its sovereign immunities. In addition, as with the Argentine default, some bondholders or other creditors could pursue international arbitration under Venezuela's bilateral investment treaties. In both cases, a favorable outcome would provide bondholders an opportunity to target Venezuela's substantial oil exports and assets overseas such as PDVSA and Citgo facilities.

Creditors may also be able to use courts in the United States to block recognition under Chapter 15 of the Bankruptcy Code of any potential Venezuelan insolvency proceeding involving PDVSA, and to leverage U.S. sanctions by liaising with OFAC and ensuring that it adequately considers creditors' interests in any sanctions-related decisions.

Additionally, both creditors and other parties with exposure to Venezuela, PDVSA or Citgo should also be prepared for complications involving sanctions against both Venezuela and Russia, and potential disputes over the ownership of and governance of Citgo.

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1. Collecting and Resisting Unfavorable Restructuring Offers

In Venezuela's case, its sovereign bonds' terms suggest that New York courts will be similarly favorable to creditors seeking to collect.

A creditor's first question in a default is obvious: how to recover an investment in Venezuelan bonds?

Litigation. One option is to pursue litigation. Both Venezuela's and PDVSA's bonds are usually governed by New York state law, and generally agree to submit to the jurisdiction of the state and federal courts in Manhattan — the U.S. District Court for the Southern District of New York or the Commercial Division of the New York County Supreme Court. Certain bonds appear to also provide for the option to sue in London or Caracas instead; needless to say, we anticipate that few creditors will choose Caracas. As with all commercially tradeable sovereign and quasi-sovereign debt issuances, they contain broad waivers of sovereign immunity.

These courts were the preferred resort of creditors during Argentina's sovereign default, and generally performed well at protecting creditors' rights against involuntary efforts to nullify Argentine debt. The Southern District of New York, primarily through now-Senior Judge Thomas P. Griesa, enforced Argentina's debt obligations, enforced collections and enjoined efforts to cut out bondholders who refused to agree to coercive restructuring proposals. While much of that litigation turned on the specific bond terms — Argentine debt, notably, did not contain Collective Action Clauses that might have allowed a supermajority of bondholders to force a restructuring over holdouts' objections — it certainly demonstrated that New York courts are not inclined to retroactively rewrite bond terms in a default.

In Venezuela's case, its sovereign bonds' terms suggest that New York courts will be similarly favorable to creditors seeking to collect. Older Venezuelan bonds, of which a substantial amount remain outstanding, do not contain any Collective Action Clause; sovereign bonds (but not PDVSA bonds) issued after approximately 2001 contain Collective Action Clauses, but relatively creditor-friendly ones. In general, its bonds with Collective Action Clauses require 75-85 percent of principal outstanding to approve changes to a relatively broad class of fundamental terms. Importantly, bonds held by or on behalf of Venezuela itself are not counted toward this threshold under the terms we have reviewed, meaning that Venezuela cannot buy its own bonds and use them to force through a restructuring.

Similarly, Venezuela's bonds contain robust *pari passu* clauses, in some cases closely echoing the language of the Argentina bonds. *Pari passu* clauses reflect the principle that bond debt is senior unsecured debt and is entitled to equal priority with other bond debt. This prevents Venezuela from making a payment to a subset of bondholders or paying other external public debt, without also making payments to all remaining bondholders across all bond instruments. While some bonds contain a carve-out for "such exceptions as may be provided by applicable legislation," this language appears to have been copied from certain corporate bonds and we believe for a number of reasons that New York courts would interpret this language as referring to the applicable law — New York law.

Bond creditors also have robust rights under the bonds' negative pledge or limitation on liens provisions, which generally prohibit Venezuela or PDVSA from granting security interests over their property unless it equally secures the bond debt, subject to certain narrow exceptions. These terms are particularly significant because PDVSA has reportedly granted a lien in favor of Rosneft over oil and gas assets, including half of its shares in Citgo. The negative pledge clause may allow bondholders to attack this preferential grant of security to ensure that PDVSA's assets remain available to all its non-subordinated creditors equally.

As an alternative to litigating before national courts, creditors in certain countries may explore the option of resolving sovereign debt disputes with Venezuela through investment treaty arbitration.

International Arbitration. As an alternative to litigating before national courts, both bondholders and trade creditors in certain countries may explore the option of resolving sovereign debt disputes with Venezuela through investment treaty arbitration. Venezuela is party to 25 bilateral investment treaties and two free trade agreements. Creditors organized under the laws of Canada, Denmark, France, Portugal, Spain and Sweden are in a particularly good position to take advantage of their country's treaty relations with Venezuela.

Two ICSID[1] decisions, *Abaclat* and *Ambiente Ufficio*, have confirmed bondholders' rights to pursue claims over sovereign debt in investment arbitration. Investment arbitration poses the significant advantages over regular litigation, as awards confirmed at the selected seat are entitled to near-automatic enforcement in any New York Convention state. That is significant because sanctions make it much less likely than in the Argentine default that significant assets will be in the United States, meaning that a litigation judgment may lead to extensive and complex proceedings to seek its domestication abroad.

In *Abaclat and Others v. Argentine Republic*,[2] thousands of Italian bondholders represented by eight major Italian banking institutions initiated arbitral proceedings against Argentina arising out of the country's 2001 debt crisis. The tribunal flatly rejected Argentina's attempt to exclude bonds from protection as "investments" under the Argentina-Italy BIT. The tribunal also allowed the claimants to bypass the court process selected in the bond instrument. Following these favorable rulings, the parties entered into a settlement agreement in 2016, under which Argentina agreed to pay the bondholders 150 percent of the original value of the bonds[3], plus costs of the arbitration.

A second tribunal in *Ambiente Ufficio S.p.A. and others v. Argentine Republic* confirmed many of these principles and upheld jurisdiction over collective claims related to Argentine sovereign debt bonds.[4] Notably, the tribunal held that where a BIT covers instruments held by a large number of investors, the drafters for both States arguably anticipated bondholders being able to proceed collectively through arbitral channels.

Taken together, both *Ambiente* and its predecessor, *Abaclat*, show that investment arbitration may prove to be a favorable forum for resolving an eventual sovereign debt default. We note that certain limitations exist. First, the disputed investments need to have been channeled through a vehicle that is organized under the laws of a

State that is party to a BIT with Venezuela. Second, each BIT provides a different scope of protection depending upon the terms agreed between Venezuela and the other State party. Careful analysis of the language of the applicable treaty is crucial.

Collections and Fraudulent Transfers. Once creditors have obtained a judgment — either in litigation or in international arbitration — the next step is, of course, to enforce it. Bondholders have a powerful tool due to Venezuela's broad waiver of sovereign immunity to pursue assets anywhere in the world, although diplomatic and military assets probably remain out of reach. In an oil-exporting country, this is highly significant, and sanctions enhance creditors' ability to collect by forbidding Venezuela from repatriating profits from PDVSA's U.S. facilities or Citgo.

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To be sure, Venezuela will undoubtedly undertake efforts to resist collection efforts. Nonetheless, the presence of much of the global financial system in New York gives creditors significant power to exert pressure against both Venezuela and intermediary institutions that might otherwise be tempted to assist Venezuela in evading creditors. Moreover, PDVSA has assets in a number of Caribbean jurisdictions that have reputable legal systems with rights of appeal to either the UK's Privy Council or the Netherlands' Supreme Court.

Bankruptcy Litigation. Creditors should also be prepared — primarily on the defensive side — to litigate in the bankruptcy courts. For example, some say that PDVSA may declare bankruptcy to attempt to restructure its obligations. While no such procedure currently exists for state-owned companies in Venezuela, Venezuela may attempt to create a bankruptcy procedure for PDVSA. If any eventual bankruptcy judgment does not protect external creditors' rights, creditors may need to resist enforcement through litigation in the United States and other jurisdictions where PDVSA has assets. In the United States, that would occur through Chapter 15 of the Bankruptcy Code.

2. The Sanctions Angle

Finally, investors should be aware that both Venezuela and Russia, its major lender and the possible source of a refinancing effort, and their respective state-owned companies, are or may be subject to sanctions in the United States and other countries. While most Venezuelan bonds themselves are exempt from sanctions under OFAC Venezuela General License 3, these sanctions may have impacts on bondholders' options. First, sanctions could impact where Venezuela holds overseas assets that could be used to satisfy a judgment or arbitral award. Second, sanctions may impact whether any proposed restructuring will pass regulatory muster. Almost any restructuring will require the issuance of new debt, which is prohibited by the sanctions when the maturity period is longer than 30 days (or 90 days for PDVSA) absent a license from the Department of the Treasury. Investors should also be aware of other potentially sanctioned parties who may be implicated in Venezuelan debt negotiations. For example, Rosneft's involvement in a restructuring may implicate both Russia and Venezuela sanctions, and investors should thus seek legal advice related to sanctions clearance.

There appears to be a growing consensus that no mutually acceptable resolution to Venezuela's debt crisis can occur under the current Maduro regime. Mismanagement of Venezuela's economy has caused this crisis, and the international community has no confidence in their ability to resolve it. Yet options remain for bondholders who proactively seek legal protection. Collection efforts against oil exports may prove difficult but fruitful during the Maduro regime. If democracy is restored, the possibility of Venezuela reentering international capital markets creates the prospect of a mutually beneficial solution to be reached.

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1 The International Centre for Settlement of Investment Disputes. Despite Venezuela's withdrawal from ICSID in 2012, it remains a party to numerous treaties providing for investment arbitration, which could occur either through the ICSID Additional Facility or UNCITRAL.

2 ICSID Case No. ARB/07/5.

3 The total agreed settlement amount was US$61,200,000 plus EUR969,065,839.

4 ICSID Case No. ARB/08/9.

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