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Creditors' Options In Venezuela's Disorderly Default

By **Javier Rubinstein, Lauren Friedman and Joseph Sanderson**

After months on the precipice of default Venezuela's President Nicolás Maduro has acknowledged that Venezuela and its state-owned oil company Petróleos de Venezuela SA 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.

Javier Rubinstein

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. Yet 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 contain collective action clauses have high thresholds before holdouts can be forced to restructure, and these thresholds will be difficult to reach. Under these circumstances, we may expect an Argentina-style disorderly default.

Lauren Friedman

By analyzing the case law from Argentina's default in 2001 and the terms of the Venezuelan bonds, it is possible to predict how a disorderly default might play out. In this article, we examine key elements from Argentina's default in order to predict whether history is likely to repeat itself.

Many Venezuelan Bonds Offer Similar Terms to Those Subject to Argentine Default in 2001

Joseph Sanderson

First, like Argentina, Venezuela included in its bonds an agreement to litigate claims before New York courts, usually 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 also provide for the option to sue in London or Caracas, but we anticipate that few creditors will choose Caracas. Both Venezuela's and PDVSA's bonds are governed by New York state law. Finally, as with all commercially tradable sovereign and quasi-sovereign debt issuances, including Argentina, they contain broad waivers of sovereign immunity.

The New York 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. The terms of Venezuela's sovereign bonds 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 a collective action clause. Sovereign bonds (but not PDVSA bonds) issued after approximately 2001 contain collective action clauses, but relatively creditor-friendly ones. In general, Venezuela's bonds with collective action clauses require 75 to 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, 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 Argentine 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 carveout 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.

Case Law Following the Argentine Bond Default May Impact the Resolution of a Venezuelan Default

As with the Argentine default, some bondholders or other creditors could pursue international arbitration under Venezuela's bilateral investment treaties. A favorable outcome would provide bondholders an opportunity to target Venezuela's substantial oil exports and assets overseas such as PDVSA and Citgo Petroleum Corp. facilities. Venezuela is party to 25 bilateral investment treaties and two free trade agreements. In particular, Venezuela has agreed to arbitrate disputes with nationals and companies organized under the laws of Canada, Denmark, France, Portugal, Spain and Sweden.

Two ICSID decisions, Abaclat and Others v. Argentine Republic and Ambiente Ufficio SpA and others v. Argentine Republic have confirmed bondholders' rights to pursue claims over sovereign debt in investment arbitration. Investment arbitration poses 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 the Abaclat case 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 plus costs of the arbitration.

In the Ambiente case a second tribunal confirmed many of these principles and upheld jurisdiction over collective claims related to Argentine sovereign debt bonds. 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 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 sovereign 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

Creditors having obtained a judgment — either in litigation or in international arbitration — may meet resistance in enforcement. Like Argentina, Venezuela gave bondholders a powerful tool due in the form of a broad waiver of sovereign immunity, although diplomatic and military assets probably remain out of reach. In the case of Argentina, collection proved challenging at first but creditors

eventually leveraged the pari passu clause described above in order to enforce their judgments. While Venezuela will certainly try to resist enforcement, circumstances suggest that collections may prove easier this time.

At the time of its default Argentina held relatively few assets overseas. Bondholders seeking to collect on their court judgments famously attempted to attach a naval ship parked off the coast of Ghana, an attempt that failed on sovereign immunity grounds. Unlike Argentina, however, Venezuela is an oil-exporting country with considerable assets overseas. According to a recent report by Forbes, PDVSA is the 19th largest oil company worldwide and produces about two billion barrels of oil per day. In addition, PDVSA owns the U.S. oil company Citgo. Citgo in turn owns three major refineries in the U.S. and about 6,000 gas stations. Therefore, assets potentially available for attachment include garnishment of payments for oil from PDVSA, garnishments of royalties paid by third parties to Venezuela and oil tankers and other physical goods. Moreover, PDVSA has assets in a number of Caribbean jurisdictions that have reputable legal systems with rights of appeal to either the U.K.'s Privy Council or the Netherlands' Supreme Court.

Even if creditors' attempts to collect on these assets fail, Venezuelan bondholders can leverage their right to payment on pari passu terms, much as the Argentine bondholders did after that default. As explained above, the pari passu clause 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. This means that Venezuela cannot appease some creditors by paying them off first. In such a case, bondholders could seek to prevent transfer of funds to preferred creditors in order to satisfy their own judgments. Much like in the case of Argentina, the presence of much of the global financial system in New York gives creditors significant power to exert pressure against Venezuela as well as intermediary institutions that might otherwise be tempted to assist Venezuela in evading creditors.

Finally, 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 the bond debt, subject to certain narrow exceptions, is also secured. 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 nonsubordinated creditors equally.

Conclusion

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 Venezuela's ability to resolve it. Yet options remain for bondholders who proactively seek legal protection. Perhaps the most important difference between the Argentine and Venezuelan defaults will be the wide availability of positive precedent to help creditors navigate the default this time around.

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