"There's a man going round, taking names. And he decides who to free and who to blame. Everybody won't be treated all the same."

- Johnny Cash, "The Man Comes Around"[1]

Venezuela's Restructuring: A Realistic Framework

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Abstract

Venezuela is confronting an economic and financial crisis of unprecedented proportions. Its economy remains on a precipitous downward trajectory, national income has more than halved, imports have collapsed, hyperinflation is about to set in and the government continues to follow a policy of prioritizing the payment of external debt over imports of food, medicine and inputs needed to allow production to resume. Bad policies are complemented by bad news as oil production and prices have declined dramatically from previous highs. On the financial side, the country is burdened with an unsustainable level of debt and has lost market access. Venezuela will be unable to attract the substantial new financing and investment required to reform its economy without a comprehensive restructuring of its external liabilities.

The Republic and its national oil company, PDVSA, are facing what may be the most complex and challenging sovereign debt restructuring to date. This paper, authored by Mark A. Walker, Managing Director and Head of Sovereign Advisory at Millstein & Co., and Richard J. Cooper, a Senior Partner in the Restructuring Group at Cleary Gottlieb Steen & Hamilton, LLP, proposes a framework for restructuring and discusses the key issues that will arise during the restructuring process, including the vulnerability of PDVSA assets outside Venezuela to actions by creditors, whether the restructuring should be implemented in one or two steps, the use of nontraditional techniques to seek to address sovereign and quasi-sovereign debt, incentives to and disincentives that may persuade would-be holdout creditors to join a restructuring and the admissibility and treatment of various claims.

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[1] Music by Huddie Ledbetter (1888-1949), musician, songwriter and murderer—rerecorded with new lyrics and again popularized by Johnny Cash.

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As the humanitarian, economic, financial and political crisis intensifies in Venezuela, so too does the complexity of the tasks the country must accomplish to reverse the 18 years of mismanagement and policy distortion that marked the presidencies of Hugo Chavez and Nicolas Maduro. The difficulty of reforming the economy in the aftermath of these failed policies is compounded both by the need to carry out this reform in what is likely to be a wrenching change in the political landscape and by the fact that there are stakeholders in Venezuela with a strong interest in maintaining the status quo. That said, Venezuela has no other choice but reform and political change.[3] The current government has openly opposed the reforms necessary to stabilize the Venezuelan economy and create the conditions for sustained growth. It has lost legitimacy and credibility internationally as well as domestically. The President and many of its senior representatives are isolated from discourse by sanctions imposed by the United States, and the acquisition and trading of new debt is now prohibited by the same U.S. sanctions, with other countries likely to follow.[4] Accordingly, we start from the premise that the only Venezuelan government that will be able to carry out a restructuring of Venezuela's liabilities is a government—which could be a caretaker or transitional government—that demonstrates a credible commitment to the necessary reforms and can undertake binding obligations in a restructuring whose validity under applicable laws is not subject to challenge.

Our focus is Venezuela's external obligations—bond indebtedness, unsecured and secured loans from private investors, bilateral and multilateral credits, amounts due to providers of goods and services, compensation claims for expropriations and claims for conversion of currency—and our objective is to provide a framework for dealing with these obligations in a fashion that both reflects Venezuela's current economic and financial situation and will accommodate the actions that the Venezuelan government must take to stabilize and rebuild its economy and to exploit its wealth of resources for the benefit of the nation. This framework is much more than an exercise in parsing the provisions of Venezuela's bond documents and speculating on a viable legal strategy. It must start with the outcome that Venezuela needs to achieve, which is policy reform and sustainable debt; it must honestly assess the amount of new financing that Venezuela will require to assure this outcome and be compatible with the requirements of multilateral and bilateral providers of funds; it must realistically and conservatively account for the amount and timing of incremental oil and gas revenues and the investment needed to generate these revenues; it must anticipate and address the substantial risks that Venezuela faces from hostile creditors; and it must, in light of all of this, provide a restructuring strategy that meets the country's objectives while addressing the realities of its financial and legal challenges.

1. **Venezuela Faces Enormous and Unprecedented Challenges**.

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[3] We assume, for purposes of this paper, that the current regime will continue its policy of seeking to avoid a default on its external bond debt by attempting to sell its portfolio of Government securities at distressed prices and providing greater oil, gas and mineral rights to Russia, China and others on concessionary terms. This, of course, will only make the inevitable and necessary task of restructuring and reforming the Venezuelan economy more difficult and, once there are no more assets or rights to monetize, will potentially leave Venezuela's government with the added complexity of managing a disorderly default.

[4] On September 13, 2017, the European Parliament adopted a resolution to encourage the European Council to freeze assets of, and restrict access to, the European Union by Venezuelans suspected of committing human rights violations. *See* Resolution of 13 September 2017 on EU Political Relations with Latin America, Eur. Parl. Doc. P8_TA-PROV(2017)0345, *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2017-0345+0+DOC+PDF+V0//EN.

No other patient in the sovereign restructuring ward has presented an array of symptoms as challenging as Venezuela, all of which must be addressed in designing a workable framework for restructuring its debt and reforming its economy:

- The economy has collapsed and hyperinflation is now a real threat.
- The amount and diversity of its liabilities—totaling $196 billion[5] or more—creates enormous practical challenges and likely contentious issues among and between creditors.
  - Unsecured bonds represent $63.3 billion, less than half of the country's total external liabilities, of which the Republic accounts for $36.1 billion, PDVSA $26.5 billion and EDC $0.7 billion. Not surprisingly, holders of Venezuela and PDVSA bonds each argue that their bonds merit preferential treatment based on legal or practical considerations.
  - In October 2016, PDVSA issued $3.4 billion of bonds secured by 50.1% of the shares of CITGO Holding Inc. ("CITGO Holding"). Unless PDV Holding Inc. ("PDV Holding"), the grantor of the pledge, avails itself of Chapter 11 protection, these bonds may be accelerated and the CITGO Holding shares foreclosed on if PDVSA defaults on any other series of its bonds, raising important financial and strategic concerns given the importance of CITGO to PDVSA's operations.
  - China/CDB and Russia/Rosneft have, we estimate, outstanding claims of $28.1 billion and $9.1 billion, respectively. Their role in and expectations for a restructuring will be critical in influencing the eventual outcome, not just as a result of their status as bilateral lenders but also as shareholders in the IMF, which itself will be a critical player in any restructuring.
  - Claims of suppliers and contractors may be on the order of $59.8 billion and will need to be addressed if PDVSA (or its successor) has any realistic expectation of attracting new foreign investment.
  - Claims and settlements arising from expropriations are estimated to be $16 billion and are in various stages of litigation or enforcement, including efforts by Crystallex to attach assets of PDVSA and challenge the pledge of CITGO Holding shares to bondholders and Rosneft.
  - Multilateral institutions such as the Development Bank of Latin America (CAF) and the Inter-American Development Bank (IDB) have outstanding claims of $5.3 billion in the aggregate.
  - Other bilateral creditors, excluding China and Russia, and commercial banks have approximately $2.1 billion of claims in aggregate.

[5] Consists of $120.2 billion of financial debt and forward oil sales and $75.3 billion of other liabilities, such as estimated supplier and ICSID claims.

   - PDVSA has other creditors such as the Japan Bank of International Cooperation which has $2.2 billion of secured loans and other unsecured lenders with $3.8 billion of claims. PDVSA also has approximately $2.8 billion of other non-financial liabilities.

- The effort to identify and reconcile all claims will be contentious and time-consuming.

- The validity of substantial claims may be challenged on a variety of legal grounds (including lack of legal authority, arguments based on concepts of odious debt and fraudulent transactions), and demands for repatriation of stolen funds will no doubt escalate if the current government is no longer in power.

- The country's most valuable assets—CITGO and receipts from the export of petroleum—are located outside Venezuela and are vulnerable to disruption and seizure by creditors.

- Venezuela will need to borrow substantial new money that in the first instance will materially increase its debt and its gross financing needs.

- Venezuela has severely curtailed investment due to liquidity constraints, particularly during the last two years, and it will need to attract massive new capital flows to fund new and deferred capital expenditures.

- Oil production and exports (essentially Venezuela's sole source of foreign exchange) are declining at alarming rates and significant increases in production will take substantial time and investment. Moreover, there is little expectation of significant oil price increases in the near term.

- The local banking system has withered, and trade finance is non-existent.

- Dealing with holdout creditors will be a formidable challenge given the absence of a legal regime to address PDVSA's liabilities and the nature and terms of the collective action clauses that exist in most of the Republic's bond indebtedness.

2. The State of the Venezuelan Economy and its Implications for a Future Restructuring.

The Venezuelan economy is in a dire state and in greater disrepair than that of any other country that has sought to restructure its obligations in recent times.[6]

According to the International Monetary Fund, Venezuela's GDP has fallen by more than 30% from 2013 to 2017 and all available indicators point to a further severe contraction in 2017. Neither the United States nor any country in Western Europe or the rest of Latin America has ever experienced a decline of this magnitude (including during the Great Depression). National income, inclusive of the price effect, has fallen by 51%, and income of the median worker has declined by 75% (in constant prices) from May 2012 to May 2017. Measured in dollars at the black-market exchange rate, it has declined by 88%, from $295 per month to just $36.

Imports per capita are estimated to have fallen by 75.6% in real terms from 2012 to 2016, and trade finance is non-existent. Imports have further declined by double-digits in 2017.

The banking system has collapsed. From 2012 to 2016, assets of the banking system at the black-market rate fell from $23.1 billion to $1.7 billion, and bank equity fell from $4.4 billion to $190 million.

From January 2014 to August 2017, prices of Venezuelan crude have declined by 52%. According to OPEC, oil production has fallen by 413 thousand barrels per day during the same period based on secondary sources. Additionally, the effects of hurricane Harvey have created added pressures on Venezuela's capacity to export crude oil.

Venezuela's external liabilities exceed 150% of GDP, and Venezuela's public external debt and debt service as a share of exports exceed that of any other country by a large margin. Venezuela has and has had for some time a primary deficit, which means that it has had to rely on external financing and arrears to fund the day-to-day operation of the public sector and to service its large debt service obligations. Since Venezuela can no longer access the market to finance its deficits, it has resorted to borrowing from its central bank, which sets in motion a self-fulfilling cycle of inflation and exchange rate depreciation that swells the Bolivar value of its outstanding foreign currency liabilities and debt service even further.

In addition to addressing urgent humanitarian needs, Venezuela must fund a dramatic increase in imports to rebuild the country's productive capacity, boost oil production, repay critical suppliers at least a portion of their past due receivables, fund a large backlog of deferred capital expenditures, repair its financial system and at the same time reduce inflation and unify the exchange rate. The result will be a substantial increase in public and private external debt

6 Except as otherwise noted, the following summary of Venezuela's economy is drawn from ongoing work by Ricardo Hausmann, Miguel Angel Santos, Ricardo Villasmil, Douglas Barrios, Frank Muci and Jose Ramón Morales at Harvard's Center for International Development. Since much essential data is not publicly available or cannot be confirmed, the figures cited should be considered approximations. The Millstein sovereign advisory team is engaged in additional efforts to analyze and confirm the data but does not anticipate a change in the conclusion that Venezuela's debt is not sustainable and must be restructured.

and the fiscal deficit. This is the principal reason why nations that are recovering from deep and extended economic depressions normally need to run primary deficits to climb out of the well.

We believe that a reasonable estimate of Venezuela's GDP is on the order of $100-$120 billion. With external public debt that is well in excess of that amount and that will need to grow substantially to finance its recovery program, Venezuela would have to run massive and continuing primary surpluses just to stand still. We estimate that Venezuela would need to maintain primary balances in excess of 9% of GDP just to keep its debt-to-GDP ratio at its current level. This would require historically unprecedented performance and is clearly not a realistic scenario.[7] Accordingly, we conclude that Venezuela's external public debt is not sustainable. Venezuela needs a comprehensive reorientation of economic policy, extraordinary financial assistance and, as discussed below, a restructuring of its liabilities.

3. **Restructure Now or Later: One Step or Two**.

Some commenters have suggested that Venezuela would be better off deferring a restructuring of its external liabilities and instead should focus in the near term on a reprofiling of principal payments (with, perhaps, some reduction in interest). The idea would be that a holiday from principal payments for three to five years would provide Venezuela adequate breathing room to implement significant reforms and increase oil production and exports that would increase the country's capacity to pay and possibly obviate the need for any debt reduction. These commentators argue that during this first stage, a well-founded determination could be made as to whether or not a deeper restructuring is in fact required. If so, then a second, deeper restructuring could be carried out.

We believe this approach is mistaken and would prove illusory.

First, any conclusion that Venezuela can continue to service its existing debt (let alone the significant new debt that will be required to support the necessary policy reforms) relies on extremely optimistic projections of substantial near-term increases in oil revenues to replace a primary deficit with large and ongoing primary surpluses, an assumption that is neither grounded in reality nor supported by experience.[8] Today, PDVSA is cash-flow negative even without debt service (except to the extent that it is able to finance accounts payable through arrears), and meaningful increases in production will take substantial investment and time to develop.

Second, we believe that proponents of this view very substantially underestimate the magnitude of new financing and investment that Venezuela will need in order to increase its imports and implement fundamental monetary and fiscal policy reforms, and the consequent widening of the current account and fiscal deficits. To be clear, we are not speaking only of new investment in the oil sector—which we expect will largely be made by the private sector and will take years before it produces significant new revenues—but more generally of funding for the country's ambitious recovery program. In terms of order of magnitude, even in a scenario of optimistic foreign direct investment and capital repatriation, adding up to US$ 50 billion, the

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7 The IMF has publicly declared that it is wholly unrealistic to expect Greece to maintain a primary surplus of 3.5% year after year.

8 Historically, Venezuela has not increased oil production year to year by more than 125,000 barrels per day except in extraordinary circumstances.

financing gap of the country is likely to remain above some US$ 100 billion for the next five years. The IMF is the only institution with the capacity to marshal resources that come close to this level of magnitude, but even it is unlikely to cover more than half of the anticipated gap. One would hope that funding from other multilateral and bilateral sources will be available to complement the funds available from the IMF and repatriated capital, but the amounts available from other sources are limited and repatriation will be both slow and unpredictable.

In terms of accessing IMF funding, Venezuela's quota under the IMF is SDR 3.723 billion—or $5.294 billion at current exchange rates.[9] Absent compliance with the rules for exceptional access to IMF funding, Venezuela may not borrow more than 145% of its quota in any year or 435% in the aggregate. For a country to qualify for exceptional access without recourse to a debt restructuring, the IMF must conclude "with a high degree of probability" that its debt (including debt to be incurred from the IMF and others as contemplated by its IMF-approved program) is sustainable.[10] Failing such a showing, the country must undertake a restructuring that will allow it to satisfy this condition.[11]

Any reasonable IMF program adopted by Venezuela will inevitably require both a dramatic increase in external debt (as noted) and a reordering of priorities away from full and current payment of bondholder claims to the provision of basic goods and services and support of policy reform. Taking into account the current performance of the economy, a reasonable but optimistic path of recovery and the terms of Venezuela's external liabilities, we do not believe that Venezuela will be able to make the required showing of debt sustainability, even without a high degree of probability. Reprofiling of bonds alone (accounting for less than half of Venezuela's external liabilities) will not suffice, so any reprofiling made to satisfy the conditions for exceptional access would presumably have to include other classes of creditors, which would be an extraordinarily ambitious undertaking that, even if it could succeed, would require substantial time during which Venezuela would not have access to new financing.

Third, any reprofiling that does not very substantially reduce interest payments would need to rely, in our view, on the mistaken assumption that providers of new funds would sanction the use of a substantial part of their proceeds to fund interest payments to existing creditors. We do not believe that new funders, including but not limited to the IMF, will support this use of their funds, particularly in light of the experience with Greece leading up to private sector involvement. Moreover, since there is no way to unilaterally reduce the interest owing to creditors that refuse to reprofile their debts, reducing the interest claims of participating creditors will result in reducing their claims vis-à-vis the holdouts, even if the latter are not paid for some period of time.

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9 SDR exchange rate as of September 12, 2017.

10 There are three other conditions to exceptional access: the country has exceptionally large balance of payment needs, it has prospects for regaining access to private capital markets compatible with its repayment obligations to the IMF, and it has the institutional and political capacity and commitment to implement its IMF-supported program.

11 The IMF has recently relaxed its requirements to allow exceptional access if it concludes that a country's debt is sustainable—although not with a high degree of probability—and the country agrees to a reprofiling of its debts with its creditors that allows it to defer repayment of principal due during the program period or receives financing commitments from other creditors (typically official creditors) to backstop sustainability. If the reprofiling proves insufficient, then the country must restructure its debts so as to assure debt sustainability.

Advocates of a two-step process believe that it would aid in securing agreement of creditors and reduce the potential holdout problem.[12] We disagree, and believe that this approach would increase rather than reduce the risk of implementing a successful recovery plan for Venezuela.

Our concerns are fourfold: first, we believe it is a misconception that a two-step process will materially reduce the holdout problem and could be accomplished quickly and without substantial litigation, particularly if creditors believe that the likelihood of a second step is relatively high; second, as noted above, if the reprofiling includes a reduction of interest, participating creditors will be disadvantaged; third, we believe that a two-step process will significantly complicate dealing with claimants other than bondholders; and fourth, the fear of a future second step and the continuance of a massive debt overhang will delay the recovery process by limiting capital inflows.

We have real doubts as to how successful a two-step process would be. Consenting holders will ask what they will gain in exchange for their concessions, and holdouts—unlike participants in the reprofiling—will (unless paid currently, which will severely undermine efforts to attract adherence to the reprofiling) retain their full claims for unpaid interest. Over a five-year period, the amount of unpaid interest on the reprofiled and holdout debt will be significant. If bondholders believe there is a reasonable chance of a second-stage restructuring, they will have no incentive to give up any portion of their interest claims, knowing that holdouts will retain and assert these same claims in the second stage restructuring. If participating creditors defer, but do not forgive, a portion of their interest, the build-up of interest during the period of reprofiling will be that much greater. Should a second-stage restructuring be required, accumulated but unpaid interest could materially increase the claims to be restructured. The treatment of past due interest will be yet another complicating factor that will exacerbate dealing with holdouts and thus diminish the appeal of the reprofiling, even to creditors otherwise inclined to be constructive.

Advocates of the two-step process argue that a reprofiling of outstanding bonds will aid in a subsequent restructuring because restructured debt will be exchanged for bonds of a single series (or perhaps one PDVSA series and one Republic series), incorporating in either case an aggregated collective action clause or clauses that will greatly facilitate a second-step restructuring if required. We disagree, and do not believe that bondholders that have a blocking position in PDVSA bonds at the time of the reprofiling will be willing to give up their blocking position without knowing and agreeing to the eventual, second-stage restructuring terms.[13] Similarly, holders of Republic bonds—whose claims cannot be restructured without their consent—would be giving up important leverage in exchange for short-term gain at best. If we

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[12] Some commentators have argued as well that Venezuela should seek to restructure PDVSA debt at the outset and just default on Republic debt until it has a better handle on what an eventual restructuring may look like. We do not believe that such a course makes sense. A default on Republic debt will complicate a PDVSA reprofiling and efforts to attract new money to Venezuela.

[13] Some commentators believe that this problem can be avoided by an aggressive exit consent strategy that relies on substituting a new entity for PDVSA as the obligor under PDVSA debt indentures and leaving holdouts with no claim against PDVSA post-restructuring. Whether or not such an approach can be implemented, the very fact of obtaining the requisite consents might deter parties from providing new financing to PDVSA given the residual risks that PDVSA will be held liable for such holdout debt even if the consent solicitation is effective.

are only partially correct, and a substantial number of creditors would resist a reprofiling, the two-step approach would have little to recommend it on tactical grounds and would likely generate a costly trail of litigation and uncertainty.

Further, as noted above, a reprofiling of bonds is unlikely to be adequate, even as a first step, unless accompanied by similar treatment of some significant part of the remaining claims against Venezuela. That is a task that would certainly prolong any first step and likely make it unworkable. And as hard as it might be to enlist other non-bondholder creditors to participate in a first stage reprofiling, getting them to take a second step in coordination with bondholders would be substantially more problematic and time-consuming. On the other hand, an aggressive reprofiling that would defer or substantially reduce interest as well as principal payments, but would allow other claimants to continue to be paid in full and on time, would likely be ill-received by many bondholders. We fear bondholders will be reluctant to reprofile their debt and not receive principal or substantial interest payments when other creditors are getting paid. Indeed, they may be reluctant to go down this path merely based on the fact that other creditors will be free to pursue claims that could ultimately have a dilutive effect on their eventual recoveries. ICSID creditors, for example will continue to seek to obtain judgments and pierce the corporate veil of PDSVA and, if they are successful, the ultimate recoveries of PDSVA creditors could be substantially diminished. PDVSA vendors could press their claims and obtain settlements during this period that could have a similarly dilutive impact on recoveries. All of these factors will make getting a first step done less likely.

In short, we believe that a two-step approach only makes sense if there are good reasons to believe that a second step will not be necessary and bondholders would be comfortable taking the first step on their own with little or no parallel action from other creditors, with the possible exception of Venezuela's largest bilateral creditors China and Russia. Even then, we believe it likely will take significant time, generate litigation and uncertainty and in the end be indistinguishable from a process that begins as a one-step process.

4. **To Default or Not to Default**.

Thus our framework begins with the proposition that Venezuela must restructure its liabilities at the outset. This conclusion is of considerable importance in designing an optimal approach to the treatment of Venezuela's external liabilities. The sequencing of steps that Venezuela and PDVSA must take is particularly critical given the precipitous decline of Venezuela's economy and the other factors noted above that make the Venezuelan case so difficult. The first questions that need answers are:

- Can or should Venezuela continue to service its external liabilities pending agreement on the terms of a restructuring?
- If not, when and to whom should it stop paying?
- And what are the risks of non-payment and how can Venezuela protect against these risks?

In reality, Venezuela and PDVSA have already begun informally to rearrange their liabilities and the country is financing a significant portion of its deficit with arrears, which is not sustainable. PDVSA has ceased paying or rescheduled debt of some creditors (e.g. vendors, Russia, China, etc.) and given medium-term notes to others in satisfaction of current claims. PDVSA conducted an exchange offer in the fall of 2016 that allowed it a modest extension of $2.8 billion of short-term maturities at the cost of increasing the amount of debt in question by $568 million, increasing the interest costs and pledging 50.1% of CITGO Holding stock. This was an extremely expensive and ill-advised transaction that, given the likelihood of a default today, may well result in the loss of whatever equity value in CITGO remains for PDVSA and potentially put an important strategic asset at risk.

Although Venezuela has so far managed to remain current on its bonds, the cost of doing so has been enormous, and the effort is clearly not sustainable. In addition to the 2016 exchange offer, Venezuela has borrowed new funds at astronomical cost through sales of PDVSA bonds at 31% of face value, entered into expensive repo transactions and committed future oil production on terms as yet undisclosed, but which one can only assume are unfavorable to Venezuela. On top of this, the country has chosen to deny its citizens access to basic goods and services by prioritizing debt service of bonds over imports of food, medicine and essential inputs. The short-term relief afford by these actions is overwhelmed by the current cost to society of the disposition of assets at below-market prices and the long-term build-up of liabilities that will have to be satisfied in the future.

Our conclusion, therefore, is that Venezuela should cease to prioritize payment of debt over other social needs, should not expand its deficit to service financial (and other related) claims and should cease payment of these claims as soon as possible. The costs and risks already incurred by the government in pursuing its current policies have been substantial. Moreover, even if the country was able to forestall a default on its bonds for some period of time, it would not be able to satisfy the demands of all of its other creditors, a number of whom have resorted to litigation seeking to seize assets of PDVSA outside Venezuela.[14] Before turning off the payment switch on its external debt, Venezuela will need to formulate and implement a strategy to address the legal and practical challenges that this policy change will bring. We suspect that Venezuela has already begun this process but its efforts will have to take on a greater urgency as the inevitable impending default approaches.

Accordingly, we see as the first step and priority in any restructuring process the implementation of measures to protect the country's assets, particularly those vulnerable to seizure, such as the proceeds from the sale of oil, while it simultaneously commences discussions with the IMF, bilateral lenders such as China and Russia and market participants[15]—a process that will take several months at the least. Once the nation's assets are secure, Venezuela will be able to enter into good faith negotiations with the official sector and its creditors, use its scarce foreign exchange in the best interests of the country and stop immediately the pursuit of dangerously uneconomic transactions whose sole purpose is to avoid a bond default. In these

14 Seeking Venezuela assets to repay its approximately $1.2 billion ICSID arbitration award, Crystallex recently initiated a turnover action against the Bank of New York Mellon to compel the turnover of Venezuelan government funds held in an account at that bank.

15 In the case of market participants, we believe the best approach would be to conduct discussions under the aegis of an ad hoc committee of Republic and PDVSA bondholders.

circumstances, negotiations with creditors can proceed on the basis of rational analysis of the Venezuelan economy, a sound recovery plan and the financial needs and prospects of the country, rather than a single-minded focus on the threat of seizure of assets and interruption of the flow of foreign exchange into the country.

Knowing that a default is both inevitable and necessary, Venezuela must have as its highest priority the objective of protecting PDVSA's cash generating assets located outside Venezuela. There are two complementary approaches that Venezuela can take to accomplish this goal. The first consists of measures undertaken by PDVSA to remove PDVSA assets from the reach of creditors, and the second is to seek legal protection in the form of a stay that would preclude creditors from pursuing PDVSA and its assets outside Venezuela. Importantly, the former does not require the assistance or actions of any legislative or judicial body, and we turn to those measures first.

5. **Protecting PDVSA Critical Assets**.

Regardless of how PDVSA goes about restructuring its obligations, it needs to take steps to protect its critical assets from adverse creditor actions. With respect to its foreign exchange generating assets (primarily receivables from the export of oil and gas), PDVSA has several options:

- It can substitute an unaffiliated entity whose accounts payable and payments to PDVSA are effectively safe from attachment, seizure or restraint to make an initial purchase of its oil, gas or other products destined for export. This tactic has been used in the past by private sector companies worried about the risk of creditor action and by national oil companies, such as Société Nationale des Pétroles du Congo, when facing similar risks. While it would no doubt involve incremental costs to PDVSA and some legal risk, at this juncture PDVSA may have no real choice but to follow this path. Indeed, there is growing evidence that PDVSA is pursuing such a strategy already, as exemplified by its arrangements with China and Russia.

- PDVSA could also enter into "true sales" type transactions where upfront funding is provided by one or more third parties in exchange for the sale of current or future receivables or future production. These sorts of transactions have been utilized by other national oil companies to raise financing in the past under different circumstances (e.g. Pemex, PDVSA itself, etc.) and could be utilized by PDVSA to mitigate the risk of adverse creditor action. We see this not so much as a step to be taken at the outset of a restructuring but more as a tool to consider utilizing either as part of a restructuring or once a restructuring has been effected if holdout creditors remain.

- Finally, PDVSA could transfer of all or part of its current or future oil and gas receivables to Banco Central de Venezuela in partial payment of the trillions in local currency it owes to the Central Bank. We discuss this alternative in more detail below in the context of creating a viable framework for the restructuring of the Republic's external liabilities.

Unfortunately, with respect to its other major asset, its interest in CITGO, PDVSA may have less room to maneuver. PDVSA holds its interest in CITGO through two U.S. companies: PDV Holding and its wholly owned subsidiary CITGO Holding, both of which are Delaware corporations. PDV Holding has pledged 51% of its interest in CITGO Holding to the collateral agent for the 2020 PDVSA bonds and the other 49% to Rosneft, the Russian oil giant.

A default under any PDVSA debt larger than $100 million risks a cross-default under PDVSA's secured 2020 bonds. Although a default on the PDVSA 2020 secured bonds would not itself trigger a default of CITGO debt or of debt at the CITGO Holding level (approximately another $2.5 billion of debt), it would enable holders of PDVSA's secured 2020 bonds to exercise remedies against PDV Holding's CITGO Holding shares which, if successful, could trigger change in control redemption provisions of CITGO debt and initiate a value destructive chain reaction at CITGO.

Protecting the PDVSA group from the seizure of its interest in CITGO Holding is therefore paramount. Faced with this situation, PDVSA will have two realistic options. First, it can file PDV Holding for Chapter 11 to obtain the benefit of Chapter 11's automatic stay. Although not ideal from PDVSA's perspective, it would at least provide it with some breathing room to formulate a plan to safeguard its strategic interests in CITGO. PDV Holding's creditors may seek to lift the automatic stay "for cause" in order to continue to prosecute their enforcement actions,[16] but showing "cause" is a high burden in Chapter 11.[17] From PDVSA's perspective, like any shareholder of a debtor that enters Chapter 11, PDVSA will need to evaluate the advantages and disadvantages of PDV Holding's filing for Chapter 11, including the tradeoff between the risk of losing any residual equity value in CITGO if it fails to file and the risk of potential exposure to possible claw back actions arising from dividends and other distributions taken out of PDV Holding by PDVSA in recent years if it does file. A filing by PDV Holding will also expose PDVSA to U.S.-style litigation and discovery as part of the Chapter 11 process—something that it will presumably wish to avoid. PDVSA's second option is to seek some sort of standstill with the 2020 PDVSA secured bondholders (and possibly Rosneft, if it continues to retain its lien on 49% of PDV Holding's shares of CITGO Holding) to forestall a Chapter 11 filing. PDVSA's bondholders may prefer this course of action to avoid the destruction in collateral value that will almost certainly take place during the Chapter 11 proceeding, which is likely to be a lengthy one given the multitude of parties (including Republic creditors) that are likely to appear and take an active role.

6. <u>General Restructuring Framework</u>.

With their most important and vulnerable assets at least temporarily secure, the Republic and PDVSA can pursue a broader restructuring strategy that will allow them time to design and

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16 11 U.S.C. § 362(d).

17 *See, e.g., In re DBSI, Inc.*, 407 B.R. 159, 166 (Bankr. D. Del. 2009) (considering, inter alia, resulting prejudice to the debtor from granting request, whether hardship to party seeking lift-stay "considerably outweighs" hardship to debtor and whether lifting stay will impede orderly administration of debtor's estate). Moreover, even if lift-stay relief is granted to a party to continue in-progress litigation, later enforcing a successful judgment often requires bankruptcy court approval. *See, e.g., In re Project Orange Assocs., LLC*, 432 B.R. 89 (Bankr. S.D.N.Y. 2010) (granting stay relief to continue prosecuting pending state court real property dispute but barring debtor's eviction without bankruptcy court approval).

implement needed policy reform. That strategy will require separate and distinct approaches for each of PDVSA and the Republic. However, each approach will share a set of common objectives:

- If and to the extent possible, achieve an effective stay of creditor actions, both to provide time to develop an appropriate economic and financial plan and to minimize the risks that creditors pose to PDVSA's ability to continue to generate foreign exchange, a risk made more difficult given PDVSA's footprint outside of Venezuela.

- Develop a plan that can attract the support (whether enthusiastically or reluctantly) of a substantial majority of bondholders and other creditors, as required to assure its implementation. Obtaining broad support will require identifying incentives and disincentives to foster participation and a credible legal strategy that the market will accept with confidence.

- Create conditions to attract new money from official and unofficial private sources.

- To the extent possible, align creditor interests with the country's long-term interests so all stakeholders benefit from a recovery of the economy and the return to normalcy.

A. Restructuring PDVSA Debt

Given the nature of its business and the critical role it plays in Venezuela's economy, PDVSA presents a unique set of challenges not generally present in the sovereign restructuring context. These challenges arise not only from the fact that it has important and potentially vulnerable assets outside Venezuela that creditors may seize, interfere with or seek to disrupt, but, as noted above, it has issued secured debt to bondholders that may jeopardize the way it interacts with CITGO, an important strategic asset. The challenges of restructuring PDVSA's debt are also complicated by the fact that it is in desperate need of new funding and is reliant on the provision of goods and services by third parties, who are increasingly reluctant to extend credit or enter into long-term arrangements with it, given past actions by it and the Venezuelan government and the precarious financial and operational situation in which it finds itself. There is also the complication that the Republic's creditors have sought, and will continue to seek, to pierce the corporate veil of PDVSA and its subsidiaries, and that the validity of and amounts due under billions of dollars of vendor notes, bonds and other debt of PDVSA (e.g., original issue discount bonds) may be disputed (a frailty shared with the Republic).

Ideally, any restructuring framework for PDVSA would take these factors into account. The issues of protecting assets from seizure by creditors, identifying and adjudicating disputed or potentially invalid claims, resolving inter-creditor disputes and creating the conditions to encourage new investment are the sorts of issues that bankruptcy courts regularly address for private sector enterprises and are part and parcel of the normal restructuring process that takes place under their supervision. For sovereigns and quasi-sovereigns such as PDVSA, there is normally no formal process to address and resolve these types of issues. Nonetheless, we believe that in the case of a restructuring of PDVSA's liabilities, such a process could be of enormous strategic value to PDVSA, particularly if it offered the possibility of obtaining a stay of creditor action, binding dissident creditors to an agreed plan, having a court adjudicate disputed claims, creating conditions that will promote new investment and managing a process that is likely to be chaotic and complicated. Moreover, even if used solely as a potential threat, the prospect of such a process could prove invaluable to motivate creditors to pursue a consensual restructuring and to allow PDVSA to garner the broad support that will otherwise be difficult to achieve, given the absence of collective action clauses in PDVSA's bonds and the risks that holdout creditors pose to its continued operation.

So what type of reorganization process might be available and how could it be used in the case of PDVSA? We see two viable paths for PDVSA to access a potential court-supervised reorganization process. The first lies in the enactment of a new local insolvency law that would enable PDVSA and other Venezuelan public sector entities to restructure their debts in an equitable, collective proceeding under the supervision of an independent judge in Venezuela. That process would be supplemented by a nearly contemporaneous Chapter 15 filing in the United States (and in other jurisdictions that have adopted the United Nations Model Law on Cross Border Insolvencies or have other local law mechanisms to grant recognition to the Venezuelan filing) to protect PDVSA's assets from creditors that otherwise might seek to resort to judicial processes outside of Venezuela.[18]

Should that effort fail, either because Venezuela is unable or unwilling to adopt such a law or fails to revise its local insolvency law as required to earn recognition in the United States or because U.S. courts refuse to recognize a Venezuelan process or a resulting restructuring plan, we believe the next best alternative for PDVSA would be to take an indirect path to access a "bankruptcy reorganization-like" process. Specifically, PDVSA would solicit consents to support new restructuring terms for its debt and approve the amendment of the terms of its bonds so that they are governed by English law and submit to the jurisdiction of the English courts. PDVSA would then seek to implement the agreed restructuring plan through an English law scheme of arrangement. Although not entirely free from risk (and certain to be challenged), based on the language in PDVSA's debt documentation and consistent with the Second Circuit's recent *Marblegate* decision,[19] we believe the "governing law" and "jurisdiction" clauses of PDVSA's bonds could be changed by majority vote for each series of bonds to English law and jurisdiction. The scheme approved by an English court would then be recognized in the United States through a Chapter 15 process (and possibly other ancillary proceedings in different jurisdictions) to achieve a similar end. Although affording less protection and of more limited

18 Chapter 11 relief, however, is unavailable to the Republic and could only be available to PDVSA if it could prove that it is not an instrumentality of Venezuela. The Bankruptcy Code makes Chapter 11 available to a "person," which term "includes individual, partnership and corporation, but does not include governmental unit." 11 U.S.C. § 101(41). Included in the definition of a "governmental unit"—and therefore ineligible for chapter 11 relief—is a "foreign state" (i.e., Venezuela) as well as an "instrumentality . . . of a foreign state." 11 U.S.C. § 101(27). Accordingly, if PDVSA is found by a bankruptcy court to be an "instrumentality" of Venezuela, then it would be ineligible for Chapter 11. Although "instrumentality" is not defined in the Bankruptcy Code, bankruptcy courts would analyze its purpose, functions and relationship with Venezuela. Whether or not a bankruptcy court could be persuaded that PDVSA is not an instrumentality, we believe that neither the Republic nor PDVSA (nor its creditors, in an involuntary bankruptcy) would likely turn to Chapter 11 to restructure their debts for practical and commercial reasons.

19 *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Fin. Corp.*, 846 F.3d 1 (2d Cir. 2017).

scope than having a Venezuelan adjustment plan recognized and enforced through a Chapter 15 proceeding (as discussed below), this approach, if successful, would nonetheless offer PDVSA a credible path to stay bondholder actions and bind holdout bondholders.

1. *PDVSA: Enactment of the Venezuelan Public Sector Revitalization Law*

Although the Venezuelan Commercial Code (*Código de Comercio*) offers two methods of relief to entities that cannot pay their debts as they come due—moratorium (*atraso*) and bankruptcy (*quiebra*)—many commenters believe that neither is available to PDVSA.[20] Accordingly, the first step to tackle PDVSA's outstanding liabilities, and send a clear message to international and other creditors that Venezuela is serious about tackling its economic problems and protecting PDVSA's assets, is the enactment of a public sector reorganization statute that allows PDVSA (and, potentially, other public sector entities) to address excessive liabilities in a collective, centralized proceeding that offers PDVSA a chance at relief and its creditors the opportunity to appear and be heard in such a proceeding. We refer to this law as the "Venezuelan Public Sector Revitalization Law."

Interestingly, a possible blueprint for this law already exists. In 2014, facing a similar inability to access a debt restructuring regime because of shortcomings of the U.S. Bankruptcy Code, Puerto Rico enacted the Puerto Rico Public Corporations Debt Enforcement and Recovery Act (the "Recovery Act").[21] The Recovery Act, which was designed to ensure that Puerto Rico could continue to provide critical services to its citizens at the same time as it pursued a stable and orderly restructuring, contemplated two paths to restructure its debt. Chapter 2, a market-based approach with limited court involvement, allowed for the approval of a consensual debt restructuring if at least half of the debt to be compromised voted, and at least 75% of the amount voted approved the modifications. Chapter 3, a court-based approach, more closely mirrored Chapter 9 of the U.S. Bankruptcy Code and permitted modification of the debtor-instrumentality's debt with the consent of at least one creditor class and pro rata payments to creditors within each class—all under the supervision of a special restructuring court. Importantly for Venezuela, the reason the U.S. Supreme Court invalidated the Recovery Act, preemption by the federal bankruptcy code, would of course not apply to Venezuela.

The Venezuelan Public Sector Revitalization Law should be constructed to provide PDVSA and other public sector entities[22] the ability to restructure their debts fairly and effectively and to minimize the risk that a U.S. Bankruptcy Court would refuse to recognize and enforce the law and any resulting restructuring plan. To accomplish these goals, the Venezuelan Public Sector Revitalization Law should:

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[20] *See, e.g.*, Jose Muci-Abraham, ¿Son Aplicables a Petróleos de Venezuela S.A., y a sus empresas filiales, las disposiciones del Código de Comercio relativas a la quiebra?, 79 Revista de la Facultad de Ciencias Juridicas y Politicas 111, 111-38 (1990).

[21] Puerto Rico Corporation Debt Enforcement and Recovery Act, 2014 P.R. Laws 371. The consensual and court-supervised approaches to public entity restructurings offered in the Recovery Act mirror the tools that Congress provided Puerto Rico when Congress passed the Puerto Rico Oversight, Management, and Economic Stability Act in June of 2016 ("PROMESA").

[22] Although PDVSA is by far the most important Venezuelan entity that will need to address its liabilities, other Venezuelan public sector entities may have their own reason for taking advantage of this new law, whether it is to clean up their balance sheet so they can attract new investment or to optimize their operations for better service to their customers or rate payers.

- provide for a stay of creditor remedies;
- include a robust process to identify and recognize creditor claims;
- provide flexibility to any public sector Venezuelan debtor to classify creditor claims in a rational manner (potentially allowing separate treatment for bondholder claims, vendor claims, bilateral creditors, contingent claims such as those asserting that PDVSA is the alter ego of the Republic, etc.);
- permit the debtor to choose the best path to pursue its restructuring goals—a consensual collective action path requiring a majority of creditors to approve a plan or alternatively a court-centric process where less than a majority of all creditors can approve a plan as long as the plan meets certain minimum procedural and/or substantive requirements;
- provide the court with the authority to adjudicate disputed claims and resolve issues such as the treatment of original issue discount debt, claims of invalidity due to the absence of required legislative or other approvals or equitable defenses that might include claims that the debt constitutes "odious debt";
- provide certainty to vendors and suppliers that provide goods and services during the pendency of any proceeding to ensure the continued operation of the debtor;
- permit debtor-in-possession financing;
- allow the debtor to reorganize its operations in a manner to encourage investment and possibly the sale of assets free and clear of claims and encumbrances;
- provide a mechanism to recognize cross-border restructurings from other jurisdictions; and
- importantly, establish a dedicated and independent court to administer the Venezuelan Public Sector Revitalization Law, possibly with the power and authority to appoint mediators and other experts (including international insolvency experts) to assist the court in its duties.

It also should include provisions designed to ensure that creditors receive substantive and procedural due process, are treated fairly among themselves and that property interests are adequately protected. Venezuela also might want to include sunset or other provisions in the law that would limit its use by companies once they emerge from the process (or allow restructured entities to opt out of the insolvency regime post reorganization) so their access to the markets is not negatively affected by the law.

To be clear, the Venezuelan Public Sector Revitalization Law need not replicate U.S. insolvency law, as Chapter 15 courts have consistently held that foreign insolvency laws need not incorporate identical protections afforded to creditors under U.S. insolvency laws.[23] Indeed,

[23] Courts granting relief consider whether such relief, "consistent with principles of comity, will *reasonably* assure" just treatment of creditors, protection against prejudice in the foreign proceeding, prevention of

foreign main proceedings in Mexico, Argentina, Chile and Brazil, to name just a few neighboring jurisdictions, have routinely been recognized and enforced in Chapter 15 courts despite the fact that the insolvency regimes of these jurisdictions differ substantially from U.S. insolvency law and the plans that emerge from such proceedings look different from what they would look like had they been effected through a U.S. Chapter 11 process.

Although it is hard to imagine that a reorganization law such as this could be enacted today in Venezuela absent a political agreement that would allow the National Assembly to enact the law and to provide for the establishment of an independent court to oversee proceedings thereunder (which actions could be ratified by the Constituent Assembly), the enactment of such a law and the establishment of an independent court is not without precedent. Leaving aside the recent Puerto Rico precedent, sovereigns in Ireland, Iceland, Greece, Cyprus and Kazakhstan, to name just a few recent examples, have reformed their legal regimes and enacted new laws as part of a process to manage the collapse of a local financial system or an important public enterprise or state function. While PDVSA is by far the most important state owned entity that could access the law, it may not be the only one to use it. Other state-owned Venezuelan entities may have reason to do so given their liabilities or the need to cleanse contingencies through an organized legal process before seeking to access new investment. Even in the case of PDVSA, reorganizing its functions so that it is no longer responsible for funding and carrying out certain state functions and services outside its core business could have enormous benefits both from a legal and practical perspective, particularly in light of the plethora of alter ego suits that have been, or are likely to be, brought.

From a restructuring perspective, we believe that a Venezuelan Public Sector Revitalization Law should mirror the two-tiered consensual and in-court restructuring approach embodied by Puerto Rico's Recovery Act and embedded today in PROMESA, the statute adopted by Congress to address Puerto Rico's financial challenges. A mechanism like Chapter 2 of the Recovery Act, or Title VI of PROMESA (with lower consent thresholds), would provide PDVSA with the ability to negotiate a flexible solution with its creditors to restructure its debt on a consensual basis and, after attaining the requisite majority of creditors and approval by the Venezuelan court overseeing the proceeding, bind holdout creditors. The Venezuelan Public Sector Revitalization Law should also, in our view, contain a mechanism like Chapter 3 of the Recovery Act and Title III of PROMESA to serve as the stick to the consensual proceeding's carrot. The fact that PDVSA's debt does not contain any collective action mechanism and that PDVSA itself does not have access to any meaningful restructuring regime means that it lacks any real negotiating leverage if and when a restructuring gets under way. Indeed, we believe the mere enactment of a Venezuelan Public Sector Revitalization Law that includes a Venezuelan court-based process for PDVSA to bind creditors to a non-consensual restructuring may spur reluctant creditors to participate in the consensual process and could mitigate the cost and uncertainties of litigation, just as the passage of the Recovery Act encouraged creditors of the

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fraudulent transfers and distribution of value in a manner that approximates the absolute priority rule. *See* 11 U.S.C. § 1507(b) (emphasis added); *In re Rede Energia S.A.*, 515 B.R. 69, 104 (Bankr. S.D.N.Y. 2014) ("[A]lthough Brazilian bankruptcy law does indeed differ from U.S. law in certain respects . . . [t]his Court will not decline to extend comity and grant additional relief simply because Brazilian bankruptcy law is not identical to U.S. bankruptcy law.").

Puerto Rico Electric Power Authority to support a consensual restructuring even as they challenged the law in courts.[24]

2. *Facilitating Chapter 15 Recognition in United States*

We assume that creditors will challenge any petition filed by PDVSA seeking Chapter 15 relief on the grounds that that PDVSA itself is not eligible for relief under the Bankruptcy Code, that a proceeding under the Venezuelan Public Sector Revitalization Law does not qualify as a "foreign proceeding" to which the U.S. Bankruptcy Court should grant comity and that relief granted under the Venezuelan statute is manifestly contrary to U.S. public policy. We believe that PDVSA would have sound arguments to refute each of these objections.

Some commentators have argued (despite the lack of supporting case law directly addressing the issue) that PDVSA would not be eligible for Chapter 15 relief because it does not qualify as a "debtor" under Chapters 7, 9, 11, 12 and 13 of the Bankruptcy Code, as it is neither a "<u>person</u>" nor a "<u>municipality</u>," as defined under the Bankruptcy Code. In our view, however, the language of Chapter 15 (and its predecessor Chapter 304 of the Bankruptcy Code) and the intent of Congress when adopting Chapter 15 do not support this conclusion.[25] Chapter 15 grants recognition and relief to a "foreign representative" of a "debtor," and the availability of relief under that Chapter is not limited to a "<u>person</u>," as defined in § 109(a) of the Bankruptcy Code. Importantly, a "debtor" under Chapter 15 is defined as "an <u>entity</u> that is the subject of a foreign proceeding."[26] Because PDVSA is likely to be considered a "governmental unit," which in turn

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[24] The Recovery Act was enacted in June 2014. Soon thereafter, notwithstanding challenges to the Recovery Act in court, PREPA and 60% of its creditors entered into a Standstill Agreement that stayed creditor actions and provided PREPA with cash flow relief.

[25] 11 U.S.C. § 101(13) (defining "debtor"). In the view of these commentators, PDVSA cannot satisfy these definitions because it is an "instrumentality of . . . a foreign state" (i.e., Venezuela) and therefore qualifies as a "governmental unit," which is excluded from the definition of a "person" eligible to be a debtor. *See* 11 U.S.C. §§ 101(27) (defining "governmental unit"); 101(40) (defining "municipality"); 101(41) (defining "person"). However, while some *entities* are specifically barred from Chapter 15 relief in § 1501(c), governmental units are not—reflecting Chapter 15's broader, cooperative intent. Its statement of purpose closely tracks the Model Law's, aiming for cooperation between U.S. courts and foreign courts, greater legal certainty for trade and investment and fair and efficient administration of cross-border insolvencies. *See* 11 U.S.C. 1501(a). Moreover, § 1508 instructs that U.S. courts interpreting Chapter 15 "shall consider its international origin, and the need to promote an application . . . that is consistent with the application of similar statutes adopted by foreign jurisdictions." Accordingly, narrower definitional provisions of the U.S. bankruptcy code should not be used to preclude PDVSA's access to Chapter 15.

Chapter 15 cases recognize this principle, *see In re Tri-Continental Exch. Ltd.*, 349 B.R. 627, 632 (Bankr. E.D. Cal. 2006) ("The status of a debtor in this case as a foreign insurance company that is ineligible to be a debtor under the Bankruptcy Code by virtue of 11 U.S.C. § 109(b)(3) does not affect the availability of chapter 15 relief."). So too did Chapter 15's predecessor, Section 304 of the Bankruptcy Code. The Southern District of New York relied on § 304's broader eligibility requirements to allow the foreign representative of a foreign insurance company to seek relief ancillary to a foreign liquidation, disregarding § 109's "completely irrelevant" eligibility requirements that would have precluded such foreign insurance company from filing a U.S. Chapter 7 liquidation. *See In re Agency for Deposit Ins., Rehab., Bankr. and Liquidation of Banks*, 310 B.R. 793, 794 (S.D.N.Y. 2004); *id.* at 795 ("The fact that, under § 109, a foreign bank cannot avail itself of the full benefits of Chapter 7 liquidation in the United States in no way implies that its estate may not obtain the benefits of a foreign bankruptcy by invoking the remedies afforded by § 304."). The same logic applies to PDVSA and Chapter 15.

[26] 11 U.S.C. § 1502(1) (emphasis added).

fits within the definition of an "entity," (see 11 U.S.C. § 101(15)), we believe that PDVSA should be found eligible for Chapter 15 relief.

Some commentators have pointed to a recent Second Circuit ruling requiring that Chapter 15 debtors have "property" in the United States to qualify for Chapter 15 relief as the basis for an argument that a "governmental unit" could not be eligible for Chapter 15 relief. But even this ruling recognizes that the definition of debtor in section 1502 is far broader than the definition that exits under section 109(a) of the Bankruptcy Code.[27] We do not believe that a court faced with the specific question as to whether a "governmental unit" may be eligible for relief under Chapter 15 would ignore the language expressly included in Chapter 15 and look to another section of the Bankruptcy Code to prevent PDVSA from accessing Chapter 15.

As noted above, for PDVSA to be entitled to relief under Chapter 15, the Venezuelan Public Sector Revitalization Law must, in addition, qualify as a "foreign proceeding" to which the U.S. Bankruptcy Court should grant recognition.[28] The Bankruptcy Code requires that a "foreign proceeding" be "a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency or adjustment of debt in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation."[29] Key among these requirements is that the Venezuelan proceeding be "collective"—i.e., "one that considers the rights and obligations of all creditors"[30]—and be able to administer PDVSA's assets. Since proceedings that benefit only one creditor constituency and do not subject all the debtor's assets to the control of the foreign court have been held not to be a "foreign proceeding" that merits Chapter 15 recognition,[31] the Venezuelan Public Sector Revitalization Law should be carefully designed to administer the rights and obligations of all creditors and all of PDVSA's assets. Of course, the

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27 *See In re Barnet*, 737 F.3d 238, 249 (2d Cir. 2013) ("Section 1502 supplants Section 101—*i.e.*, it supplants the definition of debtor within the context of Chapter 15—but [Section 1502] does not supplant requirements for "a debtor under this title" not included in the [Section 1502] definition."). The authors are aware of precedent in the Bankruptcy Court for the District of Delaware that states only a "person" may be a debtor in a Chapter 15 case. However, a careful review of the record in that proceeding suggests that statement, which was not relevant to the issues in the case and was not appealed by the losing party, is rooted in an erroneous citation to Chapter 11 case law by the objecting party that raised the issue. *See* Objection, CM/ECF 51, at 7 ¶ 26, *In re Irish Bank Res. Corp.*, Case No. 13-12159 (CSS), 2014 Bankr. LEXIS 1990 at 20 (Bankr. D. Del. Apr. 30, 2014) (party erroneously citing chapter 11 precedent to claim that only a "person" or a "debtor" may seek Chapter 15 relief).

28 The authors believe that PDVSA's restructuring under a Venezuelan Public Sector Revitalization Law would be recognized as a "foreign main proceeding" under Chapter 15 because PDVSA has its center of main interests in Venezuela and its registered office and its nerve center are in Venezuela. *See* 11 U.S.C. § 1516(c) (rebuttable presumption that the "debtor's registered office" is debtor's center of main interests); *In re OAS S.A.*, 533 B.R. 83, 100 (Bankr. S.D.N.Y. 2015) (analyzing "nerve center" of debtor to determine its center of main interests). The automatic effects of recognizing a foreign main proceeding are more robust than recognizing a foreign nonmain proceeding; namely, the automatic stay bars creditor enforcement actions against the debtor and its property within the territorial jurisdiction of the United States.

29 11 U.S.C. § 101(23).

30 *See In re The Irish Bank Res. Corp. Ltd.*, 538 B.R. 692, 698 (D. Del. 2015) (quoting *In re Betcorp Ltd.*, 400 B.R. 266, 281 (Bankr. D. Nev. 2009)).

31 *See In re Gold & Honey, Ltd.*, 410 B.R. 357 (Bankr. E.D.N.Y. 2009) (denying recognition to Israeli proceeding for which recognition was sought because, inter alia, the Israeli proceeding had been initiated by a single secured creditor, the receiver was under no obligation to consider the rights of all creditors and not all of the debtor's assets would be under such receiver's control).

court administering the proceeding would have to be viewed as independent, and while that is difficult to imagine today, we believe the new law could address such concerns by establishing a specialized court and other safeguards (including potentially mediation and/or specialized insolvency expertise including from international experts) to assist the court in its duties.

A third possible challenge to a PDVSA Chapter 15 filing and any plan that emerges from its Venezuelan proceeding would likely be grounded in Bankruptcy Code § 1506. This section of the Bankruptcy Code allows a Chapter 15 bankruptcy judge to refuse to take any action governed by Chapter 15 "if the action would be manifestly contrary to the public policy of the United States." Creditors opposed to a PDVSA Chapter 15 will almost certainly argue that granting recognition to a Venezuelan proceeding, or aiding the enforcement of orders entered in that Venezuelan proceeding (such as an order entering a reorganization plan), would be "manifestly contrary" to U.S. public policy.[32] Although section 1506 can be a versatile weapon in any Chapter 15 battle, it has been relied upon to deny recognition in a relatively narrow set of circumstances. Courts have refused to afford relief predicated on the violation of prior court orders,[33] where enforcement of orders would run afoul of U.S. law[34] and where enforcement would eliminate statutorily created patent licensee rights.[35] On the other hand, creditors' "manifestly contrary" arguments fell short when the Bankruptcy Court for the Southern District of New York recently granted Chapter 15 recognition of the Bank of Azerbaijan's foreign proceeding notwithstanding the fact that Azerbaijan had amended its applicable insolvency law immediately before the Chapter 15 filing, allegedly, inter alia, to prefer Azeri creditors and dilute non-Azeri creditors' votes.[36]

If under current circumstances the Venezuelan government were to adopt a variant of a Venezuelan Public Sector Revitalization Law, we believe that it would be unlikely to gain Chapter 15 recognition because of skepticism that the law and a Venezuelan court administering the law today would provide creditors with the requisite procedural and substantive due process required. In addition, the existence of U.S. sanctions prohibiting trading and ownership of new Venezuelan securities (and sanctioning the President and other senior officials) would no doubt be used by opponents to argue that granting Chapter 15 relief to PDVSA would be contrary to

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32 Section 1506 presents has been interpreted to apply only "'where the procedural fairness of the foreign proceeding is in doubt or cannot be cured by the adoption of additional protections' or where recognition 'would impinge severely a U.S. constitutional or statutory right.'" *In re ABC Learning Ctr. Ltd.*, 728 F.3d 301, 309 (3d Cir. 2013) (quoting *In re Quimonda AG Bankr. Litig.*, 433 B.R. 547, 570 (E.D. Va. 2010)).

33 *In re Gold & Honey, Ltd.*, 410 B.R. 357 (Bankr. E.D.N.Y. 2009).

34 *In re Toft*, 453 B.R. 186, 198 (Bankr. S.D.N.Y. 2011) (relief, if granted, would likely expose actors to criminal liability under Wiretap Act (18 U.S.C. § 2511, et seq.) and Privacy Act/Stored Communications Act (18 U.S.C. §§ 2701, et seq.)); *see also In re Irish Bank Resolution Corp. Ltd.*, 559 B.R. 627 (Bankr. D. Del. 2016) (denying enforcement of order directing U.S.-based email service provider to turn over information).

35 *In re Qimonda AG*, 462 B.R. 165, 185 (Bankr. E.D. Va. 2011), affirmed on other grounds by *Jaffe v. Samsung Elecs. Co., Ltd.*, 737 F.3d 14 (4th Cir. 2013).

36 In that case, the objecting creditors lodged a litany of complaints against a newly passed Azeri bankruptcy law, decrying the alleged "absence of even basic levels of procedural or substantive due process" for certain creditors, purportedly insufficient notice to creditors and the bundling of all voting creditors, irrespective of recoveries and rights, into a single class. *See* Objection of the Ad Hoc Group of Holders of Notes Issued by the International Bank of Azerbaijan, CM/ECF 22, *In re Int'l Bank of Azerbaijan*, Case No. 17-11311 (Bankr. S.D.N.Y. 2017). The court disagreed. *See* Order Granting Recognition of Foreign Main Proceeding and Certain Related Relief, CM/ECF 38, *In re Int'l Bank of Azerbaijan*, Case No. 17-11311 (Bankr. S.D.N.Y. 2017).

U.S. policy. Whether such an argument would be successful is hard to predict, but at a minimum we believe it would weigh heavily on any court addressing these issues.

Our premise, however, is that the current regime cannot today restructure its debt and that the Venezuelan Public Sector Revitalization Law will be enacted by a government that is attempting to overcome a humanitarian and economic crisis of historic proportions created by prior administrations. Far from imposing sanctions, we assume that at such time U.S. policy will be to promote a restoration of Venezuela's economy and the revival of its democratic institutions. In that context, we believe that as long as the Venezuelan Public Sector Revitalization Law respects fundamental procedural fairness (including the right to appear and be heard), the court administering the law is independent and the relief sought by PDVSA respects property rights and is not an affront to basic U.S. constitutional or statutory rights, such a proceeding and the resulting plan should be recognized and enforced by a Chapter 15 court.[37]

We believe the analysis outlined above supports the conclusion that PDVSA should be viewed as an eligible Chapter 15 debtor and that a well-intentioned Venezuelan government can fashion and administer a law that meets the requirement of Chapter 15. Nonetheless, should these arguments fail to persuade a U.S. court, PDVSA has another option at its disposal.

3. *Exchange Offer, Scheme of Arrangement & Chapter 15 Recognition*

Should PDVSA fail in its bid to win Chapter 15 relief, we believe its next best option is to seek access to another tested "insolvency-like" regime—an English law scheme of arrangement—in order to carry out an orderly restructuring of its bonds and bind non-consenting bondholders.

A "scheme of arrangement" is a court-sanctioned agreement between a company and a class (or classes) of its creditors to restructure all the debt of that class or those classes. A scheme of arrangement is an attractive tool because it binds all creditors in a class upon an affirmative vote of 75% in value and a majority in number of all creditors entitled to vote in such class.[38] In the case of PDVSA, all unsecured bondholders would likely be considered one single class. Holders of PDVSA bonds secured by equity of CITGO Holding shares could potentially be another class. To the extent their rights and interests are sufficiently similar, other groups of creditors could be aggregated in further classes of debt. Accordingly, if PDVSA is shut out of Venezuelan or U.S. courts, it could seek the sanction of a scheme of arrangement to effect a largely consensual deal with different classes of its creditors.

Significantly, before seeking to access an English court to pursue a scheme of arrangement, PDVSA would need to secure the approval of a majority of the holders of as many of its outstanding bond issues as possible to change the governing law of the bonds from New York law to English law and to include a submission to the jurisdiction of the English courts. This step is necessary to meet English law jurisdictional requirements. Importantly, English courts have found the requisite jurisdiction to sanction a scheme of arrangement even *after* a

[37] In addition to seeking recognition of a PDVSA proceeding under the Venezuelan Public Sector Revitalization Law in the United States, PDVSA would presumably seek recognition in other jurisdictions that have similar ancillary proceeding based on the model UN Law.

[38] Those that attend the meeting in person or by proxy.

debtor successfully solicited a change in the governing law and jurisdiction clause of its applicable debt documentation from New York law and New York courts to English law and English courts in anticipation of pursuing a scheme of arrangement.[39] Critically, though PDVSA would need to solicit its bondholders to change the governing law and jurisdiction clauses of its indentures, if the 75% in value and majority in number threshold is met on an aggregated basis across all bonds of the same class then the terms of the scheme will impose the restructuring terms on all such bonds which are the subject of the scheme.

Admittedly, this strategy has significant drawbacks. First, it will take some time to effect, both to determine what debt relief is necessary, how the relief sought will relate to the treatment of other creditors of PDVSA and to those of the Republic, and what is achievable.[40] While PDVSA and its creditors are negotiating these terms, PDVSA will be without any type of court protection, and, if its bonds are in default, more litigious creditors will be seeking to exercise remedies and access New York courts to maximize their leverage.[41] Indeed, even if this strategy is successful, under an English scheme of arrangement the imposition of a stay on proceedings in the courts in England is discretionary, so there is no guarantee that an English court will in fact stay those proceedings.[42]

Second, to maximize the prospects of accessing English courts to effect a scheme as a viable way to implement the restructuring, PDVSA will need to seek to change the governing law clause in as many of its bonds issues as possible. The good news is that under PDVSA's existing New York law governed bonds, we believe that a change in governing law to English law for each series only requires the consent of a simple majority of the holders of such series.[43]

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39 *See, e.g.*, Re DTEK Finance BV [2015] EWHC 1164 (Ch) (finding jurisdiction for scheme of arrangement after change from New York to English governing law); Re Yuksel Insaat AS (Ch, 17 November 2016) (same); Re Algeco Scotsman PIK SA (Ch, 22 June 2017) (finding jurisdiction and sanctioning scheme of arrangement where company's governing law changed from New York to English as first part of potential wider restructuring of group's indebtedness and company lacked viable alternatives).

40 As a practical matter, we believe that to secure the required majorities to a change in governing law, PDVSA would have to present to bondholders the terms of the restructuring that it would seek to implement via the scheme.

41 Some commentators have speculated that because PDVSA bondholders will have to act through a Trustee and share recoveries ratably among all bondholders, they will be less inclined to litigate. We do not share that view. The corporate context is often similar, and it certainly has not dissuaded litigious funds from pursuing aggressive legal strategies either individually or as part of a pack, pressing the trustee to act (and often having their selected lawyer acting as "special counsel to the trustee" or funding the Trustee's litigation efforts on their behalf) in order to gain leverage or obtain a higher recovery.

42 We believe that if PDVSA presents its scheme of arrangement to the English court with broad creditor support (at or in excess of the 75% of bond indebtedness required to sanction the scheme), then an English court is more likely to grant a stay against other creditors seeking to disrupt the will of the consenting creditors by declining to consent to a change in governing law and jurisdiction.

43 The PDVSA indentures require 100% of creditors to consent to any change in their core payment terms and also to any change that "impair[s] the right of each Holder to receive payment of principal of, premium (if any), interest and Additional Amounts, if any, on such Note on or after the due date thereof or to institute suit to enforce such payment". This language tracks the language of the United States Trust Indenture Act (TIA), although PDVSA's bonds are not qualified under that Act and a court's interpretation of the meaning of the TIA is not binding on a court interpreting contract language in an indenture. We believe a change in the governing law of the PDVSA indentures from New York to English law could, however, be effected by majority consent based strictly on the language of the indentures, as such change alone would not affect a holder's right to "receive payment" or "institute suit to enforce" such payment. Although our view does not rely on the Second

The bad news, of course, is that because bonds are voted by series, holders could seek to block such changes by accumulating majority positions in a particular series.

Third, unlike a Chapter 15 proceeding based on a main proceeding in Venezuela, a scheme of arrangement will be limited to the restructuring of the indebtedness of each class that is the subject of the scheme of arrangement and not to other claims against PDVSA (e.g. vendor debt, contingent claimants asserting alter ego claims, bonds where the requisite approvals to be subject to the scheme are not obtained, etc.).[44]

Despite these limitations, the scheme of arrangement strategy has its appeal. As mentioned, it is a proven path to bind holdout creditors to a plan supported by a supermajority of creditors on an aggregated basis rather than a series by series basis. It also has been used by non-U.K. registered companies and it even has been used by foreign state-owned instrumentalities so long as they have a "sufficient connection" with England.[45]

As with its efforts to seek recognition of a proceeding under a Venezuelan Public Sector Revitalization Law proceeding, if the scheme of arrangement were successful, PDVSA would then seek recognition of its sanctioned scheme of arrangement in countries that have adopted the UNCITRAL Model Law on Cross-Border Insolvency in order to protect its worldwide assets from dissatisfied creditors. Bankruptcy courts in the United States have previously granted Chapter 15 recognition to sanctioned schemes of arrangement.[46] Given that PDVSA's center of main interests rests in Venezuela, not the U.K., it is likely that a bankruptcy court would recognize PDVSA's U.K. scheme of arrangement as a foreign nonmain proceeding rather than a foreign main proceeding.[47] The principal difference between the two is that much of the relief

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Circuit's recent narrow interpretation of § 316(b) in *Marblegate*, the decision could be argued to support our position. Additionally, although we are comfortable that a change from New York to English law and jurisdiction would not require 100% bondholder consent given the similarities in the two laws, we believe that a change in the governing law and/or jurisdiction to Venezuelan law or jurisdiction or using exit consents to replace PDVSA as the obligor with an entity that cannot make scheduled payments would be a more aggressive approach given the language in the indentures and the manner in which courts interpret contracts (as opposed to statutes such as the TIA).

44 Unlike the court under the Venezuelan Public Sector Revitalization Law, the English court would not be available to adjudicate certain disputes, including disputes regarding the validity of debt or inter-creditor disputes or claims relating to the treatment of OID or employee or other claims that may be important to a restructured PDVSA. Of course, the effectiveness of the scheme could always be conditioned on acceptance by other creditors of specified treatment or the settlement or resolution of other claims.

45 *See* Vietnam Shipbuilding Industry Group (Bluecrest Mercantile Bv v Vietnam Shipbuilding Industry Group & Ors [2013] EWHC 1146 (Comm)) (finding "sufficient connection" for scheme of arrangement and staying creditor actions in the English courts where the facility agreement was governed by English law and provided for non-exclusive jurisdiction of the English court).

46 *See, e.g., In re Magyar Telecom B.V.*, Case No. 12-13508 (Bankr. S.D.N.Y.) (granted Dec. 11, 2013) (Lane, J.); *In re Zlomrex Int'l Finance S.A.*, Case No. 13-14138 (Bankr. S.D.N.Y.) (granted Jan. 31, 2014) (Lane, J.); *In re Hellas Telecomm. (Luxembourg) V*, Case No. 10-13651 (Bankr. D. Del.) (granted Dec. 13, 2010) (Carey, J.); *In re Castle Holdco 4, Ltd.*, Case No. 09-11761 (Bankr. S.D.N.Y.) (granted Apr. 3, 2009) (Gerber, J.).

47 *See* 11 U.S.C. § 1502(5) (defining "foreign nonmain proceeding" as a "foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment"). U.S. courts interpret "establishment" as requiring actual business activity in the foreign jurisdiction. Mere incorporation or management of property may be insufficient. *See e.g., In re Creative Fin. Ltd.*, 543 B.R. 498, 520 (Bankr. S.D.N.Y. 2016) ("The terms "operations" and "economic activity" require a showing of a local effect on the marketplace, more than mere incorporation and record-keeping and more than just the maintenance of

that is automatically granted to a debtor upon recognition of a foreign main proceeding (e.g., automatic stay within U.S. territorial jurisdiction, adequate protection for secured creditors) is not automatically provided upon recognition of a foreign nonmain proceeding.[48] However, PDVSA's foreign representative may still seek the same relief from the bankruptcy court to complement the scheme of arrangement, including staying the commencement or continuation of actions against PDVSA or its U.S. assets.

Should PDVSA successfully pursue a scheme of arrangement, and obtain Chapter 15 recognition and a stay of holdout creditor actions, it would offer certainty to PDVSA's restructuring efforts and stymie potential litigation that would otherwise be brought by holdout bondholders.

B. Republic of Venezuela Bonds

As challenging as the restructuring of PDVSA will be, the restructuring of the Republic's debt will be no less difficult. Although it is true that all but two series of the Republic's bonds[49] include collective action clauses allowing a supermajority of holders to bind all holders to a change in fundamental payment terms, the consent thresholds in the Republic's collective action clauses are quite high (75% in all but two series, where it is 85%).[50] Significantly, none of the Republic's collective action clauses contains an aggregation concept allowing for votes to be tallied and compliance with thresholds to be measured across series. Rather, a separate vote is required for each series, which allows holders (acting alone or in concert with other like-minded holders) to acquire a blocking position in one or more series. This fact, together with the fact that two series of bonds can only be restructured with unanimous approval of their holders, make it relatively easy for an opportunistic creditor to cause mischief when it comes to Venezuela's debt.

1. *Prerequisites to an Exchange Offer: Incentives and Disincentives*

A prerequisite for any restructuring of debt of the Republic, as for PDVSA itself, is the formulation of a plan that can garner the support of a substantial majority of the Republic's bondholders. As a sovereign debtor, the Republic will have to rely on more conventional incentives and disincentives to deal with potential holdout creditors.[51] These include: ensuring

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property."). Accordingly, PDVSA will need to ensure it has a sufficient establishment in the U.K. to merit Chapter 15 recognition of a foreign nonmain proceeding.

48 *See* 11 U.S.C. §§ 1520 ("Effects of recognition of a foreign main proceeding"); 1521 ("Relief that may be granted upon recognition").

49 The Republic bonds that contain no collective action clause mature, respectively, on August 15, 2018 (with a principal amount of $1.05 billion) and on September 15, 2027 (with a principal amount of $4 billion).

50 Bonds maturing on December 1, 2018 and January 13, 2034 have collective action clauses that require 85% approval to amend fundamental payment terms. Amendments to the other terms of the Republic's bonds with collective action clauses (including affirmative and negative covenants) require the consent of 66-2/3% of the outstanding principal amount.

51 Although as a definitional matter, Venezuela qualifies as an "entity" under the United States Bankruptcy Code and a Chapter 15 case can be initiated by the foreign representative of an "entity," we do not believe that Venezuela would cede control over its sovereign restructuring to a court in the United States or England. Nor do we believe a United States court would be inclined to grant such recognition because recognition would run counter to an express purpose of Chapter 15 set forth in the Bankruptcy Code: "facilitation of the rescue of financially troubled *businesses*, thereby protecting investment and preserving employment." 11 U.S.C.

that no sovereign assets are capable of being attached or restrained by holdout creditors; if necessary (as will likely be the case), cessation of payments pending agreement on the terms of a restructuring; conditioning the availability of funds needed to finance the Republic's recovery program on a successful restructuring (a condition that the IMF is virtually certain to impose on its own, as discussed above); and exit consents. Additionally, we propose adding a more innovative structure to the mix—namely, a creditor trust. Finally, we would add a positive incentive by enhancing the new instruments issued to Republic bondholders participating in the exchange (something that also might be useful in a PDVSA restructuring).

As noted at the outset, a prerequisite to a successful restructuring for both PDVSA and the Republic is development of a plan that can attract sufficient support from creditors to assure its implementation. One way of attracting bondholder support for an exchange offer is through exit consents, which have the effect of modifying the original bond terms so as to deprive non-consenting holders of many of the protections they now enjoy. In essence, consenting holders agree not only to participate in the bond exchange but also to amend the existing bonds which they are tendering in the exchange which, by definition, will continue to be held by holdout creditors. In the case of the Republic, we advocate being as aggressive as possible without jeopardizing the ability to sustain the exit consents against the inevitable challenges that will be brought. Thus, we would propose, among other things, that events of default and remedies be limited, that the negative pledge clause be eliminated and the *pari passu* clause be narrowed, that aggregated collective action clauses be introduced, that consideration be given to changing the governing law and jurisdiction clause to a less creditor friendly jurisdiction and, as discussed in the context of a creditor trust below, a sharing clause be included. The effect of exit consents is to create an incentive for Republic bondholders to participate in the exchange for fear of being powerless to enforce their rights, should Venezuela elect not to pay non-participating bondholders.

However, we believe Venezuela can offer more to its creditors when it comes to providing incentives and disincentives. To do this, we propose that participating holders of the Republic's bonds exchange their bonds for new credit-linked notes to be issued by a newly created creditor trust, perhaps with the guarantee of Republic itself, and that the bonds tendered to the creditor trust remain outstanding.[52] The payment terms of the credit-linked notes would then, of course, embody the agreed restructuring terms.

The Creditor Trust's ownership of, and voting rights in, the exchanged Republic bonds would make it more difficult for holdout creditors to marshal requisite voting majorities under these bonds. Additionally, the inclusion of a sharing clause in the old bonds as part of the exit consents, as suggested, would require any holdout creditor that managed to recover more on its bonds than the Creditor Trust, through legal process or otherwise, to share such excess payment ratably with all other holders of outstanding Republic bonds, including the Creditor Trust itself, as well as other holdouts.

§ 1501(a)(5) (emphasis added). Additionally, the Republic is ineligible for an English law scheme of arrangement.

[52] If a Venezuelan Public Sector Revitalization Law is adopted, this entity would need to be prevented from accessing such law.

Finally, as a positive incentive for creditors to participate, we could envisage the Creditor Trust being capitalized in part with PDVSA receivables delivered to the Central Bank by PDVSA in partial payment of loans legitimately made by the Central Bank to PDVSA. The Trust's credit-linked notes would thus be supported not only by a Republic guarantee but also by an independent revenue stream of PDVSA receivables. Those receivables could be used and structured so they could act as a debt service reserve on the restructured debt or held offshore to enhance the credit of the Creditor Trust.[53]

Similar creditor trusts have been successfully used in other restructurings, both to protect payments on the restructured debt from interruption by hold-out creditors and to enhance the credit of the restructured debt.[54] In its first offer made to creditors in October of 2015, the Commonwealth of Puerto Rico offered its creditors a so-called "superbond," which effectively incorporated many of the features of the creditor trust described above and offered to include in the Trust an additional revenue source to enhance creditor recoveries. Although the creditors declined to accept the financial terms of the restructured debt, most creditors approved of the concept.

The design of the precise combination of techniques—exit consents and positive incentives—that will best assure the requisite high level of participation in a restructuring of the Republic's debt will require a great deal of thought. Given the absence of an aggregation clause in the Republic's collective action clauses and the high thresholds for activation of these clauses, one cannot escape the conclusion, however, that to succeed, any restructuring of the Republic's debt will have to consider the aggressive use of any and all available restructuring tools.

7. <u>The Restructuring Plan: Selected Issues</u>.

Although it is impossible today to forecast with any specificity what a recovery plan for Venezuela (and an adjustment plan for both the Republic and PDVSA) would look like given the scarcity of reliable and credible information and the fact that the specific policy choices of a future government are by definition unknown, it is possible to sketch out some of the key concepts that likely will be discussed as the restructuring plan develops. These issues relate both to the admissibility and treatment of claims, as well as to the content of the plan itself.

A. Admissibility and Reconciliation of Claims

Given the variety, number and amount of claims against Venezuela and PDVSA and the circumstances surrounding a number of claims, one of the first tasks to prepare for an eventual restructuring will be to determine the admissibility of claims and to reconcile the amounts to be recognized. This task will be complex, contentious and time-consuming. It will, however, be critical both to establish the universe of claims to be dealt with and to assure equitable treatment of claimants. The reconciliation of certain claims, such as those of multilaterals or final arbitral awards, may require little or no effort as the validity and amount of these claims may be agreed or finally settled by judicial process. Other claims may raise a variety of issues (many of which

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53 This type of credit support could, of course, also be provided with respect to restructured PDVSA debt.

54 Similar creditor trusts were used in the restructuring of the Mexican company Vitro S.A.B. de C.V. when it restructured its debt in 2012 and, for different reasons, in the restructuring of Transportadora de Gas del Norte S.A., the Argentine utility in 2005-2006.

have surfaced in prior sovereign restructurings), including reconciling conflicting records, valid claims subject to equitable defenses that may justify rejection of the claims in whole or in part and fraudulent or illegal claims. Of these, the second category raises the most difficult issues. For illustrative purposes, we consider four cases that fall into this category:

- claims for payment of bonds issued at substantial discounts to par or claims for payment for services billed at significant premiums to market prices,
- claims determined to be invalid or illegal based on lack of appropriate authorization or because they are “extra-Constitutional,”
- claims held by “bad actors,” and
- odious debt.

1. *Original Issue Discount and Inflated Claims*

It has been widely reported that certain issuances of debt were purchased at prices below their par or face value. In some cases PDVSA bonds were issued to Banco de Venezuela or other State owned banks and then resold to the Central Bank for the express purpose of selling them into the market or otherwise using them as currency. These bonds were then resold abroad at substantial discounts to par. Although the purchases were not initially issued with original issue discount (“OID”) directly from the issuer,[55] some in the market consider the transactions to be indistinguishable from a primary issuance. Whether or not they are technically OID bonds, we suspect there will be pressure on any new government seeking to restructure outstanding bond debt to treat these bonds (or some of them) differently from bonds issued at their full face amount. Indeed, some creditors may insist on different treatment, particularly if the restructuring involves a substantial haircut.

That said, any government trying to provide different treatment based on so-called OID will have to address a number of practical problems. How would one distinguish among bonds sold in a similar manner—would there be different treatment based on the price paid by the first offshore purchaser? Would a bond purchased at a small discount to face value really be accorded different treatment from one purchased at par? With respect to these so-called OID bonds, some might point to the fact that under U.S. bankruptcy principles, which are neither applicable as a matter of law nor necessarily dispositive, a creditor generally cannot recover original issue discount, which is treated as unmatured interest. In the end, we suspect that specific treatment of these OID-like bonds will have to be weighed against the need to attract substantial majorities of bondholders to effect a restructuring.

Similarly, it has been reported that some providers of services to PDVSA have over-invoiced to compensate for the fact that they have been told they will be paid in PDVSA promissory notes that have a market value of 25-30 cents. Should their claims be recognized at face value? The claimants in both cases will say that their claims reflect market prices, as evidenced by the yields on outstanding PDVSA bonds. Should that be a winning argument?

[55] In many cases, however, they were paid for with local currency at controlled off-market exchange rates.

2. *Bad Actors*

When Slovenia restructured "its share" of the debt of former Yugoslavia, it refused to recognize the claims for payment of debt held by "connected persons"—that is, organs of the Serbian state or persons acting on its behalf (including individuals). A process was created under the aegis of a highly regarded Swiss jurist to determine which claims would be denied on this ground. In the Slovenia case, the determinations of the Swiss expert, who disallowed a number of claims, went unchallenged. The principle rationale for the Slovenian position was that Serbia had appropriated to itself all of the assets of the central bank of former Yugoslavia and used these assets to buy Yugoslav debt at steep discounts. One can imagine a similar argument being advanced in the case of Venezuela, where it has been alleged that funds rightfully belonging to the nation have been used to fund illegal activities or invest in Republic and PDVSA bonds for the benefit of Government insiders. Given the widespread public reports of the billions of dollars that have been taken by Government insiders,[56] we suspect that many Venezuelans will be demanding that complicit creditors pay a price for their willingness to look the other away or affirmatively assist those that have corruptly benefited from their positions of power or influence over the last few years.

3. *Invalid or Illegal Debt*

One of the recurring questions that market participants commonly ask is whether there is a risk that any existing Venezuelan debt (or any new debt issued in connection with a restructuring) could be challenged on the basis that such debt had been issued without the proper legal authorization or in a manner contrary to the Venezuelan Constitution. This, of course, is not an issue unique to Venezuela, and similar challenges have successfully been made in other contexts, including in the U.S. municipal context (most recently in Puerto Rico), where courts have held that debt issued without proper authorization or that is "extra-constitutional" is illegal and has no force and effect.[57] In the case of Venezuela's existing debt stock, these concerns center mostly on debt of the Republic, in part because the Venezuelan Constitution limits the manner in which the Republic can issue debt and because it prohibits the entry into contracts of "national interest" with any foreign person or State without the approval of the National Assembly.[58]

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56 *See, e.g., Portugal investigating fraud linked to Venezuela PDVSA funds, PDVSA says,* Reuters (June 24, 2017), *available at* https://www.reuters.com/article/us-venezuela-pdvsa/portugal-investigating-fraud-linked-to-venezuela-pdvsa-funds-pdvsa-says-idUSKBN19F0SL; Ricardo Briton & Corina Pons, *Venezuela ex-prosecutor says she has evidence of Maduro corruption,* Reuters (Aug. 23, 2017), *available at* https://www.reuters.com/article/us-venezuela-politics/venezuela-ex-prosecutor-says-she-has-evidence-of-maduro-corruption-idUSKCN1B329R; Ethan Bronner & Michael Smith, *Why Witnesses to Venezuela's Catastrophic Corruption Keep Turning Up in the U.S.*, Bloomberg (Dec. 8, 2016), *available at* https://www.bloomberg.com/news/features/2016-12-08/why-witnesses-to-venezuela-s-catastrophic-corruption-keep-turning-up-in-the-u-s.

57 *See* Richard J. Cooper & Luke A. Barefoot, Law 360, *Issues to Expect in a Title III Puerto Rico Restructuring*, Mar. 8, 2017, *available at* https://www.law360.com/articles/898663/issues-to-expect-in-a-title-iii-puerto-rico-restructuring (analyzing similar issues in context of Puerto Rico).

58 *See* Constitution of the Bolivarian Republic of Venezuela, Dec. 15, 1999, art. 312 and art. 150. Apart from the Venezuelan Constitution, there are other Venezuelan laws that limit the manner and amount of debt that can be issued by the Government in any year including the Venezuelan organic law for the Financial Management of the Public Sector (Law Decree 2.174 dated December 30, 2015 published in the Official Gazette 6210 Extr.

Whether or not any existing Republic debt (or for that matter PDVSA debt[59]) has been issued in a manner that makes it invalid or illegal is beyond the scope of this article, but no doubt there are serious legal challenges that could be brought at least with respect to certain issuances. The same is true with respect to debt that may be issued as part of any Venezuelan restructuring, and certainly would be the case if the authorization for such debt was based in whole or in part on the Emergency Decrees of September 2016 or May 2017 (each of which was specifically rejected by the National Assembly days after it was enacted), the approval of the National Constituent Assembly constituted by the Maduro Government in July 2017 (several Venezuelan legal scholars have argued that the Venezuelan Constitution provides that the convening of such an assembly requires the prior holding and affirmative vote of a national referendum, which of course did not take place[60]) or any changes in Venezuela's Constitution enacted by the National Constituent Assembly, given the fact that each of those possible sources of legal authority is itself subject to potential legal challenge.[61] Ultimately the outcome of any such challenge will depend upon whether (i) a future Venezuelan Supreme Court determines that the executive and legislative actions taken by the Maduro Government over the last several years that have undermined democratic institutions are valid, (ii) the Court feels bound by judicial precedent established by the current Supreme Court (comprised of Maduro appointees) interpreting the Constitution or other matters when reaching its decision and (iii) the court rules that its decision should be applied retroactively to third parties who purportedly purchased debt on the apparent authority offered up by Government at the time of the issuance of such debt. We are aware of at least one case where the Venezuelan Supreme Court has determined to apply a new

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dated December 30, 2015 (the "Public Finance Law")). The Public Finance Law specifically provides that debt issued in contravention of the Public Finance Law will be deemed null and void and will not be enforceable against the public.

[59] There is some disagreement among Venezuelan legal scholars as to whether "debt issuances" are excluded from the scope of what is covered by contracts of "national interest" but based on the text of the law it seems that it could apply to contracts with PDVSA as well. Constitution of the Bolivarian Republic of Venezuela, Dec. 15, 1999, art. 150 ("*No podrá celebrarse contrato alguno de interés público municipal, estadal o nacional con Estados o entidades oficiales extranjeras o con sociedades no domiciliadas en Venezuela, ni traspasarse a ellos sin la aprobación de la Asamblea Nacional.*" ("No contract for the national, state or municipal public interest shall be entered into with States or foreign official entities or with companies not domiciled in Venezuela, nor shall they be transferred, without the approval of the National Assembly.")).

[60] *See* Allan R. Brewer-Carías, *La Inconstitucional Convocatoria de una Asamblea Nacional Constituyente en 2017 como una Muestra Más de Desprecio a la Constitución*, *in* Estudios sobre la Asamblea Nacional Constituyente, Caracas, Editorial Jurídica Venezolana, 28, 28-46 (Allan R. Brewer-Carías y García Soto (Comp.) 2017); Jesús M. Casal, *Comentarios sobre la Convocatoria de una Supuesta Asamblea Nacional Constituyente contenida en el Decreto N° 2.830, del 1 de mayo de 2017*, *in* Brewer-Carías y García Soto, *cit.*, pp. 307-16; Miguel J. Mónaco, *Implicaciones y Consecuencias del Fraude Constituyente*, *in* Brewer-Carías y García Soto, *cit.*, pp. 395-408; Carlos Ayala Corao, *La Asamblea Nacional Constituyente de Maduro-2017: Fraude Constitucional y Usurpación de la Soberanía Popular (Inconstitucionalidad e inconvencionalidad de la Convocatoria y las Bases Comiciales)*, *in* Brewer-Carías y García Soto, *cit.*, pp.272-306; Rafael Badell Madrid, *Sobre la Convocatoria de la Asamblea Nacional Constituyente*, *in* Brewer-Carías y García Soto, *cit.*, pp. 163-65.

[61] The European Parliament's September 13, 2017 resolution "strongly condemn[ed] the elections to a Constituent Assembly of 30 July 2017 as being in breach of the separation of powers" and "along with many other international actors, does not recognise those elections or any actions and decisions taken by the newly established Assembly due to its lack of legitimacy." *See* Resolution of 13 September 2017 on EU Political Relations with Latin America, Eur. Parl. Doc. P8_TA-PROV(2017)0345, *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2017-0345+0+DOC+PDF+V0//EN.

interpretation of the Venezuelan Constitution retroactively[62] which should give pause to any investors who dismiss the potential consequences of these challenges.

4. *Odious debt*

Odious debt is a concept in international law that has its origins in the claims of state-to-state debt in the context of state succession. The question addressed by the concept of odious debt is as follows: is the successor to country A responsible for the payment of debts owed to country B that were contracted by the predecessor to country A when the funds borrowed were not used in the interests of the State, but rather to strengthen a despotic regime? In some formulations of this concept, knowledge on the part of the creditor of the misuse of the funds borrowed is an essential element of a defense to payment. One can imagine the argument being raised both with respect to certain recent bonds issued at a substantial discount and certain bilateral credits. The Venezuelan context differs from the classic case of odious debt in three significant respects: first, we assume there will be not be state succession, but rather at most a change in government; second, the "lender" of the purported odious debt will not be a state (unless this is raised in the case of Chinese or Russian debt); and third, the claims are governed by private law (New York law in the case of bonds), not international law. There is no precedent that we have found in New York law or other private law decisions in the United States for rejecting or reducing a claim on the grounds of odious debt. That said, we believe that so-called equitable defenses similar to those that underpin the notion of odious debt (such as the doctrine of clean hands) may well play a significant role in determining the outcome of a negotiated solution, which is ultimately how Venezuela's debt will be restructured.[63] Similarly, even in the case of bilateral claims, it is extremely unlikely that these claims will be resolved by decision of a tribunal applying international law.

5. *Treatment of Different Classes of Claims*

There is ample precedent for treating different classes of claims differently, and it is safe to assume not only that Venezuela will follow this example but also that issues of this nature will be highly contentious.

We need look no further than the bond indebtedness to come upon the first major issue—namely, preferential treatment for PDVSA bonds or Republic bonds. We have heard strongly articulated arguments for both positions, but make no predictions of the outcome at this point. That said, we think there are good arguments to be made, and much relevant precedent, for according similar treatment to both sets of bonds. What we do believe strongly is that it would be a serious mistake for arguments over this issue to paralyze efforts to arrive at the terms of a comprehensive restructuring for Venezuela.

The second largest category of claims against PDVSA and Venezuela belongs to suppliers and providers of services. These claims include current accounts payable, arrears and claims that have been converted to longer term obligations evidenced by promissory notes. According to PDVSA's 2016 financial statements, claims against it aggregated $24 billion at

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[62] *See* decisions 245 and 263 rendered by the Constitutional Chamber on April 9, 2014 and April 10, 2014, respectively.

[63] A court applying New York law, for example, may take equitable defenses into account.

year end 2016, and commercial claims against the Republic are said to amount to some $36 billion.[64] There is ample precedent for restructuring claims of this nature in the case of suppliers that are no longer providing goods or services and in the case of financial institutions that have purchased claims of suppliers. In the case of PDVSA, if the restructuring plan emerges from a legal process in Venezuela such as the Venezuela Public Sector Revitalization Law, we imagine that PDVSA will have significant leverage to compromise many of these claims.

Bilateral credits are another class of claims that will need to be addressed. Many of these claims may be documented as forward sales of oil, exchange of debt for rights to concessions or similar transactions that, on their face, do not appear to be financial claims. We do not believe the form of documentation should be dispositive where the clear purpose of the transaction is to provide financial support to Venezuela or PDVSA, as opposed to capital investment. It has been reported that China has agreed to defer certain principal payments, and Russia may have done so as well, but the terms of the arrangements with those countries and other bilateral creditors are not publicly available. That said, with some $37 billion or more of outstanding debt to China/CDB and Russia/Rosneft alone, it is likely that bondholders will want to see some reasonable alignment of payments to both groups. Russia and China themselves may argue to the contrary on grounds that funds supplied by them have been used, at least in part, to keep bondholders current. Bilateral creditors generally may well have credible arguments as to why their claims should be treated differently from those of bondholders. These are among the issues that will have to be sorted once the relevant facts surrounding these claims are known.

Finally, a number of private firms have made claims against Venezuela for damages relating to expropriation and the like. Some of these claims have resulted in ICSID arbitration awards and some are pending. Of the awards, some have been confirmed in court and others are being challenged. Based on data from Venezuela, PDVSA and various news reports, our rough estimate is that Venezuela's exposure may be on the order of $16 billion. Although we are not aware of meaningful precedent for restructuring claims of this nature, in at least one case (Gold Reserve), Venezuela has been reported to have reached a settlement agreement calling for payment over time. Given the sheer size of the exposure and the totality of other claims against Venezuela and PDVSA, coupled with the fact that these claims are unsecured and do not benefit from any special legal priority, it would not be unreasonable to believe that they too may be included within the scope of a comprehensive restructuring. Moreover, in some cases, Venezuela may negotiate a settlement that involves restoring the claimant to certain of the rights (or granting new ones) it had prior to expropriation.

6. *Value Recovery*

Given the depth of a haircut that may be required in the first instance, and to blunt somewhat the pressures to adopt a two-step approach to a restructuring, we envisage that creditors whose claims are compromised will receive a value recovery instrument that will allow them to share in an improvement of Venezuela's fortunes. In light of Venezuela's overwhelming dependence on oil, we believe that the most appropriate mechanism would be an instrument

[64] Estimate of commercial claims per Ecoanaltica. Represents unfulfilled obligations of the government to deliver USD in exchange for VEF received in exchange for goods and services. At least some Venezuelan lawyers believe these claims are not enforceable in Venezuela.

designed to pay based on actual increased revenues attributable to increases in the price of oil (rather than production). As increases in volume will come only from new investment, which in turn should be provided by the private sector, we would not increase value recovery payments on the basis of volume increases.[65]

8. **Conclusion**.

In the last three months of this year, Venezuela has approximately $3.8 billion in principal and interest payments coming due on Republic and PDVSA bonds alone. Despite its dwindling foreign currency reserves, rapidly falling oil and gas production and widespread shortages of basic food, medicine and inputs, the current government has indicated its intention to continue its policy of seeking to avoid a default at all costs. To accomplish this, the government will continue to sell off and mortgage the Nation's resources, likely on unfavorable terms that reflect its lack of bargaining power. If it is successful in staving off a default, holders of Venezuelan paper on the short end of the curve will no doubt cheer while Venezuela's other stakeholders will be rightfully concerned about the long-term cost and consequences of the additional burdens the nation is taking on to pay these obligations.

When the inevitable default occurs— and it will no doubt come sooner than the current regime prefers—policy makers in Venezuela will have to grapple with what may be the most complex and challenging sovereign restructuring ever, and they will need to act quickly, possibly as newcomers to government in the midst of a disorderly default. This paper attempts to provide a framework for their work—not just by setting a strategy to deal with external debt, but by anticipating the challenges they will face and the issues they will have to address. While by no means complete, we hope that it will prove useful to those who eventually will be tasked with restoring Latin America's longest running democracy to prosperity—a feat that will require not only a measure of good fortune, but a healthy dose of patience.

[65] *See* Richard J. Cooper & Luke A. Barefoot, Law 360, *What Should Puerto Rico Offer Its Creditors?* Mar. 15, 2017, *available at* https://www.law360.com/articles/900858 (explaining how Puerto Rico could offer creditors a contingent value instrument, or "growth bond," and a fixed-pay instrument to allow creditors to recoup losses due to a haircut and participate in future economic growth and recovery).