

Oh! What A Tangled Web

BY STEVEN T. KARGMAN

*Venezuela's debt
restructuring conundrum,
Part III.*

Any eventual Venezuelan restructuring is threatened in advance of the process by litigation brought by creditors against the Republic of Venezuela and PDVSA, Venezuela's state-owned oil company. This is the third in a series of articles on Venezuelan debt restructuring. The first installment of this series, in the Fall 2018 issue of *TIE*, discussed a two-sided conundrum facing Venezuela: first, the fact that Venezuela urgently needs a restructuring but such a restructuring is unlikely to take place while the Maduro regime remains in power; and, second, that a delay in initiating a restructuring is only likely to make success more difficult to achieve. The second article, in the Spring 2019 issue of *TIE*, focused specifically on the challenges posed by a deteriorating economy in general and a declining oil industry in particular for an eventual Venezuelan restructuring.

RECENT DEVELOPMENTS

Since late June, a number of major developments have had bearing on the Venezuelan situation. In early August, the Trump administration expanded on its earlier program of sanctions against Venezuela by imposing a freeze on all Venezuelan government assets in the United States. This latest step continues the Trump administration's efforts to ratchet up the economic pressure on the Maduro regime in order to bring about regime change in Venezuela.

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In the meantime, Venezuela has increasingly turned to outside sources such as Russia to fill its domestic energy needs, particularly for refined products such as gasoline. Venezuela has been facing severe fuel shortages due to the impact of U.S. sanctions, which cut off imports of gasoline and other refined products from the United States. Rosneft, the Russian state-owned oil company, has apparently entered into transactions with the Venezuelan government to supply gasoline and other refined products, and a Chinese engineering firm has reportedly been brought in for the purpose of repairing Venezuela's ill-maintained domestic refineries.

Separately, in a major ruling, the U.S. Court of Appeals for the Third Circuit upheld a decision of the U.S. District Court of Delaware in late July that, given the Venezuelan government's extensive degree of control over PDVSA, PDVSA is effectively the "alter ego" of



Citgo station in Chicago. Citgo is widely considered the "crown jewel" of the PDVSA corporate group in light of its extremely valuable assets in the United States.

*The Venezuelan situation represents
a major departure from the norm.*

the Republic of Venezuela, and thus the formal separateness of the two entities, the Republic and PDVSA, could therefore be disregarded. The Third Circuit also held that a judgment against the Republic could be satisfied by allowing the judgment creditor in that case, Crystallex International Corporation, to attach PDVSA's shares in PDV Holding, the U.S.-based wholly owned subsidiary of PDVSA. Since Citgo Petroleum Corporation, arguably PDVSA's most valuable asset, is an indirect, wholly owned subsidiary of PDV Holding, attaching shares in PDV Holding could give Crystallex a potential path to seize shares of Citgo.

This decision, unless it is overturned on appeal, could have important implications for creditors seeking recoveries against the Republic as it potentially opens up the possibility of going after PDVSA-related assets in the United States to satisfy judgments.

In another recent development, in early July both the so-called interim government (led by opposition leader and National Assembly President Juan Guaidó) and a committee of bondholders set forth their respective views on some general principles and parameters to guide any eventual debt restructuring. There was some convergence between the two sides on matters such as the principle of equality of treatment for all creditors, but

there were also some apparent differences as well. The Guaidó-led opposition indicated that it would plan to negotiate separately with China and Russia with respect to the bilateral loans from those two countries, while the committee of bondholders stated that China and Russia should not be given any special treatment.

On the political front, the stalemate between the Maduro regime and the Guaidó-led opposition forces has

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appeared to continue, and the Maduro regime remains in power after having put down an attempted uprising by the opposition forces in late April. In early August, the Norway-sponsored talks taking place between the

Maduro regime and the opposition concerning a possible political settlement in Venezuela reportedly broke off, at least for the time being, after the Maduro government withdrew from the talks. However, it was reported in late August that the U.S. government has been holding secret talks with top aides of Maduro “in an effort to find a negotiated solution to the country’s crisis,” according to the *Wall Street Journal*.

Finally, the grave humanitarian crisis facing Venezuela appears to continue unabated. Malnutrition and outright hunger have become increasingly widespread among the Venezuelan population, as reported August 20 in the *Financial Times*. Shortages in Venezuela of such necessities as food and medicine are even more serious than before, as the sanctions against Venezuela restrict its ability to trade with and import goods that it needs from other countries. The large-scale exodus of Venezuelans to other countries continues as well, with estimates that at least four million Venezuelans have already fled the country.

THREAT OF CREDITOR-INITIATED LITIGATION

As mentioned, a major risk to any future Venezuelan debt restructuring is that existing creditors to both the Republic

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and PDVSA might pursue legal actions, in advance of any restructuring, to protect their interests. In most sovereign debt restructurings, one does not usually see too much litigation until a far later stage in the process—sometimes not until a few years down the road—such as at the point when a restructuring deal has already been proposed

Promises, Promises

On the one hand, 50.1 percent of Citgo Holding stock is pledged to the holders of PDVSA bonds maturing in 2020. On the other hand, 49.9 percent of Citgo Holding stock was pledged to the Russian state-owned oil company Rosneft as collateral for a \$1.6 billion loan Rosneft made to PDVSA in 2016.

—S. Kargman

by the sovereign debtor in question and/or approved by creditors.

At a later point in the process, a holdout or dissenting creditor might pursue litigation in order to achieve a better recovery or a higher rate of return than would otherwise be possible under a proposed or approved restructuring deal. The Venezuelan situation represents a major departure from the norm, with litigation against the Republic and/or PDVSA already underway on a number of fronts before there is even any restructuring proposal on the table, and, as noted, there is unlikely to be a restructuring until there is a change in regime in Venezuela.

Not surprisingly, this early pursuit of litigation has irked some creditors who are used to the usual pattern. A *Financial Times* article in mid-March entitled “Venezuela Workout Pits Hot-Headed Newcomers Against Veterans” described this frustration on the part of certain creditors who have been through many sovereign debt restructurings without pursuing litigation so early in the process.

For creditors considering the option of litigation pre-restructuring, the logic and appeal of such a possible course of action would seem to be fairly straightforward. Such creditors might not be inclined to wait for the outcome of any eventual restructuring process since the timing might be highly uncertain and unlikely to take place anytime soon. Furthermore, these creditors may be concerned that if they exercise patience and wait for the process to unfold, they might represent merely a few isolated voices among a multitude of creditors and that their preferences for what a restructuring plan should look like might not be given much weight.

Such creditors might instead pursue their legal remedies and seek recovery on their claims on their own timetable and in the relevant courts of their own choosing (subject, of course, to the nature of the specific cause of action being pursued by the creditors). Specifically, such creditors who choose to litigate after obtaining a judgment against the Republic or PDVSA, whether as the result of an action in court or an arbitration proceeding, might attempt

to attach assets of the Republic or PDVSA. This might include potentially taking actions, to the extent possible, to attempt to seize assets of PDVSA and/or PDVSA's affiliates, for example attaching the stock of PDVSA's U.S.-based affiliates as a means of obtaining control of those affiliates. Obtaining control of Citgo would represent the ultimate prize in this quest for attachable assets.

TARGETS OF OPPORTUNITY

PDVSA in particular has valuable assets and operations outside of Venezuela. For Venezuelan creditors, perhaps the most attractive asset outside of Venezuela is Citgo, the

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U.S.-based company which is an indirect, wholly owned subsidiary of PDV Holding, PDVSA's U.S.-based subsidiary. Citgo is widely considered the "crown jewel" of the PDVSA corporate group in light of its extremely valuable assets in the United States, notably its three U.S.-based refineries with their refining capacity of approximately 750,000 barrels per day, its many pipelines, and its dozens of terminal facilities.

Apart from Citgo-related assets, creditors might also consider focusing their recovery efforts on the hundreds of thousands of barrels of oil—even at Venezuela's current much-reduced production levels—that leave Venezuela on a daily basis, as well as the cash proceeds generated from the sale of such shipments.

Yet while these oil shipments and the associated cash proceeds might seem to represent a very rich target of opportunity, it should be noted that the Republic and/or PDVSA may take various steps, if they have not already done so, to protect such shipments and cash proceeds from attachment by creditors. For example, as some observers have pointed out, PDVSA might seek to sell its oil to third parties even before the oil leaves Venezuela so that the oil and the cash proceeds would effectively be beyond the reach of creditors.

PDVSA has other valuable assets outside of Venezuela that might or have already attracted the interest of creditors as potential targets for attachment.

PDVSA has several major refineries located in the Dutch Caribbean. One creditor with a judgment against PDVSA, ConocoPhillips, was previously able to obtain attachment orders against some of these refineries, but then ultimately lifted the attachments upon reaching a settlement with PDVSA.

LITIGATION INITIATION

Certain holders of international arbitration claim awards against the Republic and/or PDVSA have commenced actions to enforce (that is, realize or collect upon) their judgments.

These arbitration awards generally relate to actions in which Venezuela, beginning over a decade ago, particularly under former president Hugo Chavez, nationalized various industries such as oil and gas, mining, and manufacturing, and effectively expropriated without compensation the property or assets of a number of foreign investors and foreign companies. Such arbitration awards were granted by arbitration tribunals such as the World Bank's International Centre for Settlement of Investment Disputes, and tribunals constituted under the auspices of the International Chamber of Commerce.

The arbitration award holders represent a potentially potent force because awards granted to these parties run into the billions of dollars, and there are also a number of arbitrations that are still pending against the Republic and/or PDVSA and such proceedings involve claims (not yet crystallized in final arbitration awards) that could also potentially run into billions of dollars.

For a sovereign debt restructuring, this represents a fairly unusual situation because arbitration award holders do not usually occupy such a prominent position, unlike, say, bondholders, who in many recent restructurings such as Argentina and Greece constituted the bulk of the outstanding debt and effectively drove the restructuring process from the creditor side. In the Venezuelan situation, the arbitration award holders are acting upon their awards during what is effectively a pre-restructuring period.

The holders of PDVSA and Republic bonds appear to collectively hold the largest slice of Venezuela's outstanding liabilities (approximately \$60 billion-plus by some estimates). However, while it is hard to put a precise number on the overall dollar amount of the arbitration awards against the Republic and PDVSA, the amount of the awards already granted taken together with the dollar amount of potential awards (based on the dollar amount of the claims asserted in pending arbitration proceedings) is not insignificant in the overall mix. Some estimates put that total amount at approximately \$15–\$20 billion.

ConocoPhillips, the U.S. oil company, holds two arbitration awards, one for \$8.7 billion and the other for \$2 billion. In early August, though, an arbitration tribunal of the International Chamber of Commerce dismissed a separate \$1.5 billion claim by ConocoPhillips against PDVSA. Crystallex, a Canadian mining company (which filed for insolvency in Canada), holds an award for \$1.2 billion plus interest, and Owens-Illinois, a U.S. glass container manufacturer, holds an arbitration award for \$500 million.

Rusoro, a Canadian mining company, held an arbitration award for \$1.2 billion (including pre- and post-award interest), but it ultimately reached a settlement with the Republic requiring it reportedly to pay Rusoro nearly \$1.3 billion in installments over a period of five years.

It is not just the dollar amounts of these arbitration awards that is noteworthy. The means by which the arbitration award holders have sought to enforce their awards has also been significant. For example, in April 2018 ConocoPhillips received an arbitration award as mentioned of approximately \$2 billion related to PDVSA's expropriation in 2007 of ConocoPhillips investments in certain major heavy crude oil projects in Venezuela.

In attempting to enforce this arbitration award, ConocoPhillips obtained attachment orders from courts in the Dutch Caribbean against several PDVSA refineries there. These attachment orders had the potential effect of seriously hampering PDVSA's ability to refine crude in the Dutch Caribbean. The case was ultimately settled in August 2018, with PDVSA agreeing to pay the \$2 billion award to ConocoPhillips plus interest over a

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period of 4.5 years, and ConocoPhillips in return agreeing to suspend its legal enforcement actions in the Dutch Caribbean.

The Canadian mining company Crystallex filed suit against the Republic in the U.S. District Court for the District of Delaware, on the basis of an arbitration award it received against the Republic for \$1.2 billion plus interest for expropriation of one of its gold mines in 2011. In

a decision in the summer of 2018, Judge Leonard Stark found that PDVSA was the so-called "alter ego" of the Republic and ruled that Crystallex could therefore attach PDVSA's shares of its U.S. subsidiary, PDV Holding, to satisfy the judgment against the Republic.

Since Citgo is a direct, wholly owned subsidiary of Citgo Holding which in turn is a direct, wholly owned

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subsidiary of PDV Holding, the ruling by Judge Stark allowing Crystallex to attach PDVSA's shares in PDV Holding gave Crystallex a path to potentially seize shares of Citgo, arguably one of PDVSA's most valuable assets.

The ruling from Judge Stark was appealed to the U.S. Court of Appeals for the Third Circuit, and, as noted, the Third Circuit in late July upheld the decision and found that PDVSA was the "alter ego" of the Republic and that PDVSA's shares in PDV Holding could be attached.

However, the ability of Crystallex to attach PDVSA's shares in PDV Holding is subject to certain factors such as permission from the U.S. Treasury (and specifically its Office of Foreign Assets Control) to execute on the PDV Holding shares in light of restrictions imposed by the U.S. sanctions regime.

By embracing the "alter ego" theory, this decision of the Third Circuit, if it is not overturned and if its reasoning is embraced by other U.S. Courts of Appeal, could have profound consequences for creditors holding judgments against the Republic. Such judgment creditors would otherwise generally have difficulty attaching Republic assets in the United States where the Republic has engaged only in non-commercial activities due to the principle of restrictive sovereign immunity incorporated in the U.S. Foreign Sovereign Immunities Act.

Nonetheless, this ability to attach the U.S.-based assets of PDVSA and/or affiliates is subject to the assumption that there are no other obstacles such as sanctions or executive orders placed in the way of creditors that would have the effect of protecting the assets.

In addition to the arbitration cases and awards discussed above, there are a number of other pending creditor-initiated lawsuits and arbitrations against both the Republic and/or PDVSA, including lawsuits brought by manufacturers that were suppliers to PDVSA and by

hedge funds that have acquired debt of the Republic and/or PDVSA.

CITGO

Even without the threat of creditor-initiated lawsuits, Citgo has another set of potential claimants whose interests could be at cross-purposes with judgment creditors seeking recovery against Citgo assets. Specifically, in order to attract third-party financing, PDVSA pledged assets (namely, Citgo Holding stock) to creditors as collateral that could be exercised upon in the event that PDVSA defaulted on its required debt service payments.

On the one hand, 50.1 percent of Citgo Holding stock was pledged to the holders of PDVSA bonds maturing in 2020. The PDVSA 2020 bonds are essentially one of the only, if not the only, series of bonds that PDVSA is currently servicing, as both PDVSA and the Republic have otherwise been in default on most of their outstanding debt since roughly the end of 2017. On the other hand, 49.9 percent of Citgo Holding stock was pledged to the Russian state-owned oil company Rosneft as collateral for a \$1.6 billion loan Rosneft made to PDVSA in 2016.

In terms of the Citgo stock pledges in favor of the PDVSA 2020 bondholders, PDVSA has a major debt service payment of approximately \$900 million due on its 2020 bonds in late October 2019, and whether PDVSA will be able to make that very sizeable payment remains to be seen.

The PDVSA situation is rendered even more complicated by the fact that the Guaidó-led interim government has appointed members to what are effectively ad hoc boards of directors for both PDVSA and Citgo. These ad hoc boards of directors exist in parallel to the already existing boards of directors that were earlier appointed by the Maduro regime.

The ad hoc board for PDVSA ordered a \$71 million interest payment to be made on the PDVSA 2020 bonds in mid-May. Thus, the decision as to what PDVSA will or will not do with respect to the upcoming October 2019 payment appears to rest with the ad hoc board for PDVSA

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appointed by the Guaidó-led interim government. The opposition-led National Assembly in Venezuela may have a role in approving the payment as well.

The ability of holders of the PDVSA 2020 bonds to exercise on their Citgo stock pledge in the event of a default could be affected by the type of U.S. sanctions in place at that particular time, including the newest sanctions imposed by the Trump administration in early August (assuming they remain in place).

As of mid-August, there have been news reports in the *Financial Times* and Bloomberg that the Guaidó-led interim government may believe that the latest Trump administration sanctions effectively put Citgo beyond the reach of the 2020 bondholders. According to those news reports, it seems that the interim government may therefore not feel any pressure to make the October 2019 debt service payment if it does not believe that it is at risk of losing Citgo by virtue of non-payment on the PDVSA 2020 bonds.

How the interim government acts in October when the payment on the bonds is due remains to be seen (assuming that the recent news reports accurately reflect the interim government's views). Will the reported views of the interim government today be the same in October when it has to make the decision? Changes cannot be ruled out given the very fluid nature of the Venezuelan situation.

Separately, only time will tell whether that apparent reading by the interim government of the impact of the latest sanctions on the Citgo Holding collateral is the correct reading. Already there seems to be some pushback from the U.S. Treasury's Office of Foreign Assets Control on this interpretation of the latest sanctions.

As reported by Bloomberg in mid-August, "...OFAC officials told creditors that they could still foreclose on the Citgo shares if PDVSA defaults on its 2020 bonds..." This critically important matter may not be settled until OFAC issues definitive guidance clarifying this issue in light of the new sanctions.

Finally, it should be noted that the ability of Rosneft to exercise on its Citgo Holding stock pledge in the event of a PDVSA default on Rosneft's loan to PDVSA could potentially be affected by considerations related to the Committee on Foreign Investment in the United States, given the Russian government's control of Rosneft. ♦