

RESTRUCTURING CERTAIN DEBT OF THE REPUBLIC OF VENEZUELA AND PDVSA ON THE SAME TERMS

Mark A. Walker & Alice Chong¹

Venezuela's public debt stock includes approximately \$36 billion of bonds issued by the Republic, approximately \$28 billion of bonds issued by PDVSA (of which some \$2.5 billion are secured by a pledge of shares of Citgo Holding) and notes issued by PDVSA to service companies and other suppliers in an amount estimated to be \$2 billion.² (See Appendix A for a summary of other external liabilities of the Venezuelan public sector.)

There has been considerable discussion of how the debt of the Republic and of PDVSA will be treated in the comprehensive restructuring of Venezuela's public liabilities that will inevitably accompany the reform and reconstruction of the Venezuelan economy when the country finally inherits a government with the will and the commitment to embrace a sound economic program. Predictably, holders of PDVSA obligations champion the superiority of their claims based on the fact that PDVSA generates virtually all of the country's foreign exchange, and holders of obligations of the Republic point to the fact that the hydrocarbons that PDVSA exploits belong to the nation—and not to PDVSA—and that PDVSA's right to exploit these resources exists solely by the grace of the government, does not convey ownership and may be withdrawn at any time.

We have long believed that social, economic and political considerations strongly argue in favor of comparable treatment of the financial debts of PDVSA and the Republic³ as part of a comprehensive restructuring of the country's external obligations. Among other things, early acceptance of this approach by creditors will eliminate the risk and distraction of a highly divisive creditor group that will complicate and delay the design and implementation of a restructuring. And at the end of the day, the decision how to organize Venezuela's oil industry—and thus the source and ownership of future oil revenues or rents—will remain largely in the hands of Venezuela itself.

We turn then to the question of how to create a framework that will naturally lead to a restructuring in which bonds issued by the Republic and bonds and supplier promissory notes issued by PDVSA are dealt with on the same terms. Lee Buchheit and Mitu Gulati have put

¹ Mark A. Walker is a Managing Director and Head of Sovereign Advisory at Millstein & Co. Alice Chong is a Director at Millstein & Co. The authors wish to thank Mr. Jose Ignacio Hernandez for his advice on Venezuelan law. The views expressed herein are those of the authors and not necessarily those of Millstein & Co.

² In addition to promissory notes issued by PDVSA to its service providers, PDVSA had accumulated arrears to them of some \$22 billion as of the end of 2016. Some of these arrears may well be restructured on terms as least as favorable as those accorded the promissory notes.

³ Non-financial obligations of PDVSA (a category whose definition is likely to be contentious) should perhaps merit different treatment depending on their nature, but this question is beyond the scope of this note.

forward one approach to achieve this objective, and Adam Lerrick has offered up another.⁴ Both proposals envisage inviting holders of PDVSA's bonds and promissory notes to exchange their claims at par for bonds issued by the Republic. Although not discussed in either proposal, having the Republic become the sole obligor for existing bonds and supplier promissory notes of PDVSA would have important consequences for future financings by the Republic and PDVSA.

The two proposals take radically different tacks, however, to discourage PDVSA creditors from declining to participate in the exchange. Buchheit and Gulati would have PDVSA grant a first lien on all of its assets to the Republic as security for the obligation of PDVSA to reimburse the Republic for amounts paid by it in respect of the bonds it issues in exchange for tendered PDVSA debt.⁵ As a result, holdouts who retain their claims against PDVSA would have recourse only to assets subject to a first lien in favor of the Republic, with no value remaining after satisfaction of that lien. Lerrick, by contrast, would have the Venezuelan government cancel PDVSA's concession to exploit the nation's hydrocarbon reserves whereupon all of PDVSA's assets would be transferred to the government and the government would assume all of the liabilities of PDVSA.

We offer a third alternative which would obviate the necessity of conducting an exchange offer (and therefore of deterring holdouts creditors) and at the same time avoid what we believe are important deficiencies inherent in the two proposals on the table. Buchheit and Gulati would relegate creditors of PDVSA other than bondholders and holders of supplier promissory notes to the same status they propose for holdouts from their exchange offer—that is holders of worthless claims. This is presumably unintended and clearly unworkable. Based on advice we have received from Venezuelan counsel, Lerrick's approach would raise difficult issues of Venezuelan law. The government cannot as a constitutional matter simply fold PDVSA into itself but would need to establish another entity to conduct PDVSA's hydrocarbon business. It is hard to see how it could do this without also transferring to that entity the assets needed to conduct that business. This would, as a number of commentators have observed, raise issues of fraudulent transfer and would be sure to attract protracted litigation that would likely become a major distraction and an impediment to the conduct of Venezuela's international oil business. Moreover, it will be necessary as a commercial matter to provide for the continued servicing of liabilities of PDVSA to persons other than bondholders and holders of supplier promissory notes.

⁴ Buchheit, Lee C. and Gulati, G. Mitu (October 25, 2017). Deterring Holdout Creditors in a Restructuring of PDVSA Bonds and Promissory Notes. Retrieved from <https://ssrn.com/abstract=3058468>

Lerrick, Adam (October 25, 2017). Venezuela's Debt: Untying the PDVSA Knot. Retrieved from <https://ftalphaville-cdn.ft.com/wp-content/uploads/2017/10/25133900/Venezuela-untying-the-PDVSA-knot.pdf>

⁵ As Buchheit and Gulati note, the negative pledge clauses contained in PDVSA's bonds allow PDVSA to pledge its assets to the Venezuelan government to secure payments due under any agreement between them. Buchheit and Gulati state that the same exception is found in the negative pledge clauses in the promissory notes. PDVSA is, of course, a party to financing agreements (including promissory notes to contractors) that are not publicly available. Some or all of these agreements and notes may have provisions that would not allow the pledge of PDVSA's assets to the Republic.

Cross Guarantees

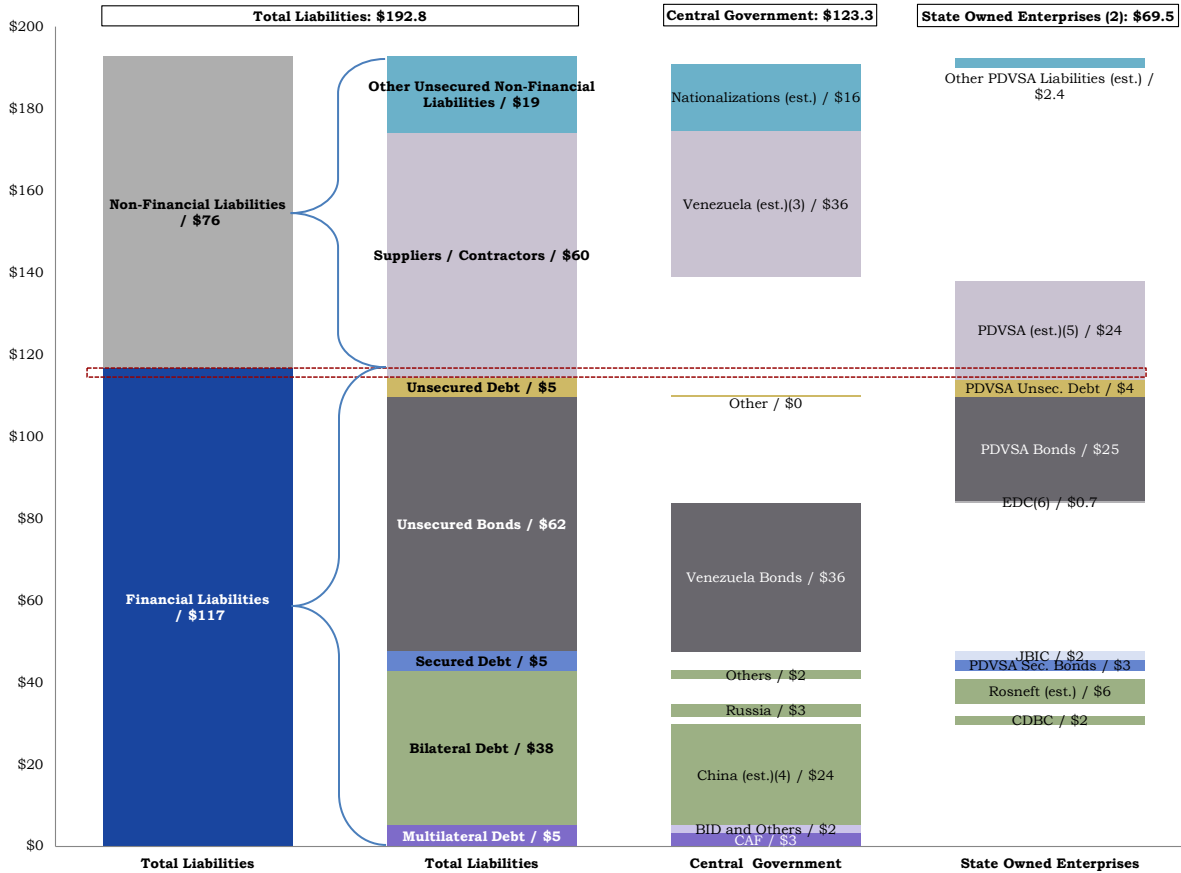
To put holders of PDVSA bonds and supplier promissory notes on an equal footing with holders of Republic bonds, we propose that PDVSA guarantee the Republic's bonds and that the Republic guarantee PDVSA's bonds and supplier promissory notes.⁶ To the extent that there are other PDVSA financial credits that should be included in the same basket, the Republic could guarantee them as well.⁷ No action by creditors would be required to issue these guarantees and thus there would be no holdout problem. Following the issuance of the cross guarantees, each covered creditor of PDVSA and each holder of Republic bonds would, in effect, have the same two primary co-obligors: the Republic and PDVSA. As a consequence, it would be natural to restructure these credits on the same terms.

Upon a comprehensive restructuring of a specified percentage of the guaranteed debt, the guarantees of any bonds or promissory notes not participating in the restructuring would automatically terminate. Additionally, the cross guarantees could be designed such that if there is no comprehensive restructuring of the guaranteed debt within a specified period of time they would automatically terminate.

⁶ We are advised that a new Venezuelan law would be required to enable the Republic to guarantee PDVSA's liabilities as Article 105 of the Financial Administration of the Public Sector would otherwise prohibit the government from issuing such a guarantee. There is direct precedent for this approach, however, as Venezuela enacted such a law when it restructured the country's external public debt under the Brady plan.

⁷ One question to be resolved is whether or not the debt of the empresas mixtas (the operating joint ventures between PDVSA and unrelated partners) should be restructured.

Appendix A: Summary of Venezuela's External Liabilities¹



¹ Excludes all internal government liabilities and liabilities denominated in Bolívares Fuertes (VEF). Government guaranteed loans are excluded due to a lack of available data. Excludes any missed interest or interest accrued on missed amounts.

² Source: PDVSA's 2016 audited financial statements, Sept. 2016 exchange offer materials, PDVSA's 2016 audited debt report, PDVSA 2016 Annual Management Report, and news sources. Excludes CITGO debt and amounts payable to Related Parties such as the BCV, Venezuela and pensions.

³ Represents estimates for unpaid imports and claims for unfulfilled obligations of the government to deliver foreign exchange per Ecoanalítica.

⁴ Source: Estimates based on Venezuela & PDVSA Annual Report, news articles, and internal analysis. Through indirect sources, we understand that China has represented that the outstanding balance of the oil-for-loans is \$22 billion. Our estimate is based on publicly available sources such as Venezuela & PDVSA Annual Report and news articles.

⁵ Approximately \$2.3bn represents promissory notes issued by PDVSA to its suppliers.

⁶ Figures reflect bonds outstanding at Electricidad de Caracas ("EDC").