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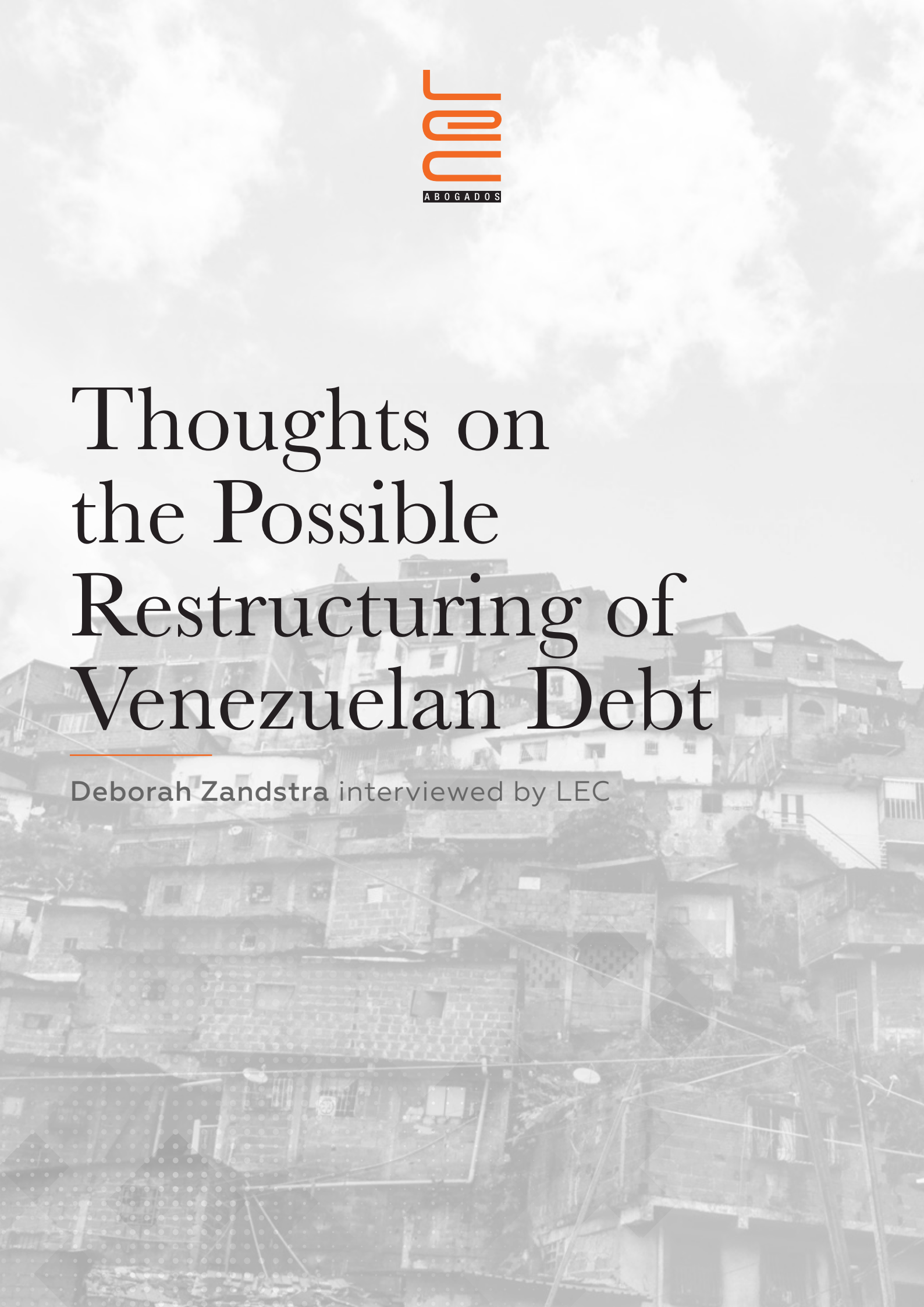
Thoughts on the Possible Restructuring of Venezuelan Debt

Deborah Zandstra interviewed by LEC



Introduction

LEC Abogados is a top-tier financing, energy and transactional law firm based in Venezuela, with a very unique practical approach to the needs of our clients. Our partners in the areas of energy, corporate finance, structured finance, banking, securities, mergers and acquisitions, bankruptcy and reorganization, real estate, construction sector and financial dispute resolution, have strong academic backgrounds in their respective areas of expertise. LEC Abogados has many decades of combined experience working in some of the most complex deals in Venezuela as well as internationally with numerous successful deals in Latin America and now in Europe from our office in Madrid, Spain.

In view of the importance of a well balance and thoughtful program to renegotiate the sovereign/Pdvsa external debt, we have decided to open up a dialogue with important stakeholders of the financial, academic, legal and institutional sectors, to discuss key elements that might be incorporated in the possible scenarios that Venezuela would face in the process of restructuring and refinancing of its sovereign debt, as well as in the funding and execution of the reconstruction of the country.

Our objective is to spread relevant knowledge and expertise and our own views as legal practitioners as to possible solutions that would be considered for a proper and comprehensive negotiation program. Venezuela deserves a brighter future and we truly believe that collectively we will find the alternatives to create solutions that align the interest of the various parties involved in this very complex process.

The views and opinions expressed in these interviews are of those being interviewed and do not necessarily reflect the opinion and position of LEC Abogados or of any of its members.

Deborah Zandstra

Deborah Zandstra is a partner at Clifford Chance LLP, where she leads the firm's sovereign debt restructuring and advisory practice and has been at the heart of many of the policy innovations of the last few years in the sovereign debt space, including advising ICMA on its published aggregated collective action clauses and enhanced pari passu provision for inclusion in sovereign notes and the IIF on its Debt Transparency Principles. Her clients include sovereigns, major international commercial and investment banks, industry bodies, insurance companies, euro area financial stability institutions and funds.

Deborah has more than 25 years of experience in a wide range of sovereign debt raising and management transactions, including advising on liability management (bond exchanges, debt buy backs and consent solicitations), debt issuances, loans (both with and without multilateral development bank guarantees), secured and structured financing transactions and derivatives, as well as debt conversion techniques relating to sovereigns, sub-sovereigns and central banks. Deborah is a graduate of Cambridge University where she studied history and law and speaks English, Spanish, Italian and French. Deborah sits on numerous industry bodies relevant to sovereign debt, including the IIF's Committee on Sovereign Risk Management, the UK's Financial Markets Law Committee's Sovereign Debt Scoping Forum and the ILA's Sovereign Insolvency Study Group.

1.
What is a sovereign debt restructuring process?

In its broadest sense a sovereign debt restructuring is the process through which the payment terms of debts, which will ultimately represent a drain on the resources of the sovereign, are altered or replaced to make them sustainable on the basis of an assessment of the available capacity to pay, given the circumstances faced by the country.

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This raises a number of questions, most of which are covered by the subsequent topics raised. These include:

1. What is the scope of debt to be restructured? The authorities appointed by the National Assembly to represent the interests of Venezuela in connection with its sovereign debt restructuring process (the “National Authorities”) made it clear that this will extend to debts which are:
    - Private claims
    - Denominated in foreign currency
    - Against the Republic of Venezuela (the “Republic”) and the Venezuelan public sector

2. Will the sovereign debt restructuring process take place as part of an economic reform programme? The National Authorities said on 3 July 2019 that they will seek assistance from the IMF and other multilateral agencies. A key and urgent part of any such programme (the “Programme”) will be the humanitarian crisis facing the country. Assuming the IMF is involved and its resources contribute to the Programme, this will mean the process will be more predictable than would otherwise be the case as the IMF will most likely draw on practices and norms it has adopted over the years in the sovereign debt restructuring context.

3. What is likely to happen to debts owed to non-private creditors? Where the IMF is involved in the process, typically, these debts are restructured through the Paris Club. But not all non-private creditors of Venezuela are members of the Paris Club and such parties may choose to pursue bilateral discussions.

4. Who forms the assessment of the available capacity to pay, given the circumstances faced by the country? This will form part of the Programme which would effectively be agreed between the National Authorities and the IMF which needs to be set out in a letter of intent from the National Authorities to the IMF. This will need to be approved by the Executive Directors of the IMF.

2.
What is the current situation of Venezuela in connection with its sovereign debt obligations?

Debt to equity programs were omnipresent leading up to and during the Brady program and these types of solutions will be the single largest contributor to Venezuela's debt reduction as part of the forthcoming restructuring process.

Those in the country are likely to have more insight on this issue, however, the following major issues are relevant:

- Humanitarian crisis.
- Failing public services and weakened government institutions.
- Inflation.
- Loss of economic activity, including in the oil sector.
- Loss of investment and good corporate governance in state-owned entities.
- Prevalent financial crime to be addressed.
- Sanctions and the difficulties of bringing about a change in circumstances allowing a restructuring to take place in a sanctions permissive regime.
- Lack of reliable data on public finances.
- Most relevant debt claims are in arrears and there is considerable ongoing litigation.
- The diversity of relevant debt claims.
- Security granted for the benefit of some creditors only.
- The absence of majority voting mechanisms in most debt claims.

3.

What sovereign restructuring precedent do you think more closely resembles Venezuela and would best help Venezuela design its restructuring strategy? Is there anything to be learnt from past Venezuela restructurings (i.e. Brady Bonds)?

All sovereign debt restructuring are unique. However, parallels can be drawn with other sovereign debt restructurings in the following areas:

- The diversity of the existing debt claims.
- Debt defaults and the proliferation of litigation.
- The significance of the oil sector to the economy.
- Extensive trade debt and promissory notes in arrears.
- The need for a significant reconciliation exercise.

Parallels with the following sovereign debt restructurings are therefore likely: Iraq (2005); USSR/Russian Federation (1997, 2000 and later FTO debt); Argentina (2005 and 2010 and NML pari passu litigation); Nigeria Trade debt restructuring (mid 1980s).

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Previous Venezuelan restructurings are inevitably relevant to some degree. However, the current position involves a deeper and more broadly based crisis than in previous restructurings. In addition, there is a greater diversity of affected debt claims and higher litigation levels arising from long standing disputes or payment defaults. There are also sanctions and concerns over significant state capture by certain individuals.

4.

Any comments on the profile of the sovereign debt and debt holders? How would you deal with such a diverse profile? Any ideas on how to validate and adjudicate claims. How should a new government grade/treat Venezuela and PDVSA debt? Publicly traded vs commercial and judgment awards?

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Engagement in some form with the diverse creditors or creditor groups or committees, if they form or continue to exist, will be an important ingredient to success. It is only through dialogue, discussion and negotiation that insights into the concerns of the various creditors will be obtained.

There are various approaches to validation of claims, and in the case of disagreement, some type of adjudication would be helpful. The National Authorities have indicated in their 3 July 2019 memorandum (the "July 2019 Memorandum") that a debt reconciliation process is contemplated. As noted, the amounts owed in respect of many claims (e.g. standard bonds and loans) are unlikely to give rise to much difficultly or disagreement in practice. Others, including claims with inflated nominal amounts, bonds issued at significant discounts and awards pending final determination on quantum have been highlighted in the July 2019 Memorandum and are likely to require more time to resolve. A memorandum on reconciliation has been promised as soon as possible and this should address any adjudication process. In practice large, international accountancy firms are one of the few institutions with the required capacity, skills and independence to carry out the role.

The July 2019 Memorandum also sets out the basic rule that reconciled claims will be eligible on the same terms as other reconciled private claims to participate in the restructuring. This will create an incentive for creditors actively to participate in reconciliation. There is a recognition that differential treatment may be granted to claims having a legitimate preference on property of the Venezuelan state or public sector entity.

5.

Considering that Venezuela holds the largest crude reserves in the world, would this need to be considered as a critical element in the sovereign debt restructuring process? (e.g. petroleum projects are capital intensive and would require access to international markets).

The sovereign debt restructuring process will seek to put the country in a position where its debt obligations (after the restructuring) are sustainable. This process will form part of the Programme to be agreed between the government of Venezuela and the IMF, which will include a debt sustainability analysis. We would expect multilateral development banks to provide support at the same time as a Programme is agreed, including the World Bank, the Inter-American Development Bank and the Latin American Development Bank.

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> In terms of sources of revenue for Venezuela, the single most important component will be receipts from the oil sector where it is well understood there has been chronic underinvestment and falling production.

We would anticipate that, with a view to increasing revenues, selected new investments into the oil sector would form part of the Programme. Given the risks of litigation some thought would need to be given to how such investments are structured so as to minimise risks of attachment.

6.

What's your opinion on OFAC sanctions in connection with Venezuelan sovereign debt?

Existing sanctions have the effect of making it very difficult in practice for a sovereign debt restructuring to take place whilst Nicolás Maduro retains power.

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> As a practical matter to implement the Programme, including the sovereign debt restructuring, all sanctions impeding that process would need to be lifted, including restrictions on trading Venezuelan bonds in the US, as liquidity is key to a successful sovereign debt restructuring.

It is likely that some sanctions will remain against individuals and their assets. That may include the use of sanctions limiting the ability of certain individuals using the sovereign debt restructuring to realise gains arising from illegitimate activities.

7.

Do you think holdouts will constitute a serious obstacle for a successful restructuring? How would you deal with them?

Given the magnitude and diversity of creditors' claims and the already existing levels of litigation and the distressed prices at which some debt claims now trade, it would be prudent to assume that any sovereign debt restructuring will close with holdout creditors. Whilst some holdout activity can be targeted at preventing a sovereign debt restructuring deal from closing, it should be possible to structure any such deal so that risks in that respect are minimised. Most holdouts prefer a sovereign debt restructuring deal to close so that they become a minority with whom the country may be prepared to settle.

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The following approaches could prove to be useful:

1. Meaningful engagement with creditors:
    - Preferably through face to face discussions with the National Authorities, in which a comprehensive approach to dealing with all relevant claims is discussed.
    - In a manner which attempts to reach the holders of as many different types of claim as is practically feasible.
    - In a manner which attempts to reach different types of holders who may have varying constraints/requirements in respect of their participation in a restructuring.
    - Some element of good faith negotiation with private creditors will be a pre-condition to disbursement of funds from the IMF.

2. Look for or develop a majority voting approach for as much of the debt as is feasible through, for example,
    - Utilising all existing collective action clauses in bond issuances, which would involve series by series voting.
    - For PDVSA and other claims owed by a corporation, rather than the Republic, develop local bankruptcy rules, by reference to internationally accepted standards (e.g. INSOL), utilise the new rules and seek recognition of them in selected other jurisdictions (e.g. UK and U.S.)
    - For local law denominated claims consider the feasibility of implementing a new local law which provides for majority voting.

- It has been suggested that an Executive Order by the US Government coupled with a collective action mechanism under which majority action by holders binds all relevant creditors (this may be limited to US holders) might be helpful. We are unaware of this approach being used in other sovereign debt restructuring contexts and it would need to be analysed carefully, most particularly by reference to its scope as it could lead to unintended consequences for that component of the U.S. capital markets occupied by foreign issuers and/or lead to an escalation of other sovereign debt crises if investors exit potentially distressed holdings more quickly where US executive intervention might be possible.

3. Consider the feasibility of a UNSCR to immunise hydrocarbon assets and their proceeds from any form of attachment (along the lines of UNSCR 1483 and 1546 used in Iraq)
    - Note any UNSCR can be vetoed by a permanent Member of the UN Security Council.
    - China and Russia are permanent Members of the UN Security Council.

4. In response to views of holders heard through dialogue with them, develop a menu of options for the restructuring from which creditors are able to choose instruments which reflect their interests so as to maximise the likely participation rate, this could include oil linked bonds, GDP linked bonds, debt for equity swaps. Many investors are likely to understand the need for a significant reduction in debt servicing costs including interest deferrals and maturity extension but in view of the potential wealth of the country and likely updated debt sustainability analyses as more data becomes available will hope for a long term recovery premium.

5. Warrants providing for value recovery issued in conjunction with the new instruments
    - The obvious linkage would be to oil revenue, the warrants would allow creditors to share in some of the gains from improvements in the sector and world prices in due course.

6. Enhance the new instruments issued in the exchange, through for example:
    - Partial interest guarantee from one or more multilateral development banks (e.g. IADB).
    - Co-financing agreement with one or more multilateral development banks.

7. Contractual provisions in the new instruments which address inter creditor equity:
    - Mandatory prepayment provisions.
    - Provisions modelled along the lines of the Paris Club comparability provision.

The first would trigger additional payments if other creditors achieved higher recoveries. The second would amount to an undertaking to seek comparable terms with other creditors.

All contractual forms of such provisions carry risks and these would need to be evaluated by reference to the circumstances likely to be faced by Venezuela.

8. Reinstatement of loss provisions in the new instruments, for example:
    - If debt forgiveness is given through the creditor accepting a face value reduction, that face value could be reinstated in certain circumstances (e.g. payment default or non-compliance with the agreed IMF Programme).

9. Use exit consents wherever feasible. This would involve amending non-payment terms of original instruments immediately before they are brought into the sovereign debt restructuring. This is only available where non-payment terms can be amended through a collective vote with a lower voting threshold than that which applies to a collective vote on payment terms. In essence, the debtor and the creditors under those instruments would be voting to amend terms which will only be of relevant to any holdouts (e.g. waivers of sovereign immunity).

10. Consider the feasibility of the use of a class action mechanism, drawing upon procedural rules in court proceedings in, say, the US (under US Federal Rule of Civil Procedure 23(b)(1)(B)). This approach would require a US court to agree to the use of a mandatory class action and for the majority of affected creditors to request that a mandatory class action is created. In broad terms, in this context, creditor recoveries are made on a rateable basis. This has been suggested in the past but not, to our knowledge, been used in a sovereign debt restructuring context. It is likely in practice to be available, if at all, to instruments with submission to courts in the US and would be likely to require considerable further legal analysis in terms of feasibility.

11. Agree an initial approach to holdout creditors as part of an overall strategy (e.g. not pay them, defend vigorously and no resources available under the economic programme to pay them) and state that position in the public documentation for the sovereign debt restructuring. This could be coupled with statements that the integrity of the underlying claims of any holdouts and the transactions under which those claims purportedly rose will

be fully investigated by the National Authorities, and any irregularities will be used to the fullest extent possible by them in any proceedings.

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> Finally, the most efficacious way to minimise holdouts would be to make the deal on offer financially attractive to creditors.

This reality needs to be balanced with the IMF's debt sustainability analysis and the need to demonstrate to those within the country that the challenges of adjustment are being shared with creditors. The use of debt relief in the short and medium term with sweeteners as conditions improve in the country over time should be able to address these objectives.

8.

What's your opinion on the possible liquidation/spin-off of assets of PDVSA into a new National Oil Company? How would you ensure the continuing operations of PDVSA/new National Oil Company, obtain access to markets and protect assets and operations?

There are more Venezuelan law / constitutional issues associated with these questions than foreign law considerations, however, we would make the following general observations:

- International recognition of domestic law bankruptcy or insolvency procedures is more likely where the (new) domestic bankruptcy or re-organisation regime conforms to international standards and the INSOL Model law would be a useful starting point.
- There are successful instances where a state owned corporation originally not subject to a functioning bankruptcy / re-organisation regime has become the subject of a new functioning such regime as a precursor to restructuring its debt obligations. Dubai World is a relatively recent example.
  Issues concerning continuing operations, access to markets and assets protection would all fall to be dealt with through the new bankruptcy /re-organisation rules.

9.

Given the complex social, economical, political, legal situation of Venezuela, where would you invest your first dollar as head of a new government? And when to start a restructuring?

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> The first priority of a newly elected government must be the humanitarian crisis.

Advisers have indicated that it is likely that 9 months would be needed to agree the IMF Programme. A sovereign debt restructuring could be started shortly thereafter. In the meantime it would be important to start the meaningful dialogue with creditors and invite their active participation in the process of reconciling claims also to mitigate against the risk of bondholders pursuing claims through the courts in an attempt not to fall too far behind other creditors.

LEC Abogados

LEC Abogados is a Law firm oriented to assist local and international clients in connection with their legal needs to implement and conduct businesses in Venezuela. Our aim is to provide international quality legal advice whilst understanding local realities.

Founded in August 2006, LEC Abogados results from the association of seven former partners of the most prestigious law firms in Venezuela, putting together a group of lawyers with a high recognition in their respective areas of expertise.

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