

RESTRUCTURING VENEZUELA'S DEBT USING *PARI PASSU*

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ABSTRACT

Given the depth of Venezuela's economic crisis, many fear that the government and the state-owned oil company Petroleos de Venezuela, S.A. ("PDVSA") are on the brink of insolvency. In this paper, we introduce a restructuring plan that would allow Venezuela to restructure its external debt in an orderly manner. We propose that Venezuela restructure both PDVSA debt and its own external debt via Exchange Offers. To maximize the number of participating bondholders and receive sufficient debt relief, we suggest that Venezuela primarily utilize the pari passu clauses included in the vast majority of PDVSA and Venezuelan bonds, which are modified versions of a typical pari passu clause and can be read to allow the subordination of the bonds in accordance with Venezuelan law. To minimize the number of holdout creditors, Venezuela can introduce a law that subordinates non-exchanged debt to exchanged debt, making timely or full payment of holdout debt unlikely. This tactic would minimize the need to rely solely on alternative restructuring techniques, such as exit consents and Collective Action Clauses (CACs). We argue that while these techniques might alone prove insufficient to successfully restructure Venezuela's debt, they could supplement the restructuring options we propose here. Because the parties contracted for debt subordination in the bond contracts, we predict that using a debt subordination technique would be more viable in Venezuela's case than it has been in past sovereign debt restructurings. Ironically, the pari passu clause that doomed Argentina might be what saves Venezuela.

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I. INTRODUCTION

Venezuela is in the midst of a severe political and economic crisis. The government and the state-owned oil company Petroleos de Venezuela, S.A. (“PDVSA”), are facing imminent default on their external debt obligations. The risk of default has arguably increased as a result of the United States’ recent sanctions targeting transactions in Venezuelan debt¹ and the destabilization of crucial oil revenues from Texas caused by Hurricane Harvey.² A default by either the government or PDVSA would be disastrous for the economy, prompting creditors to cash-strap the government by seizing its assets abroad. A debt restructuring of some kind thus seems inevitable, leading academics and practitioners to start thinking about a restructuring strategy.³ In this paper, we introduce a novel plan that would allow the Venezuelan government to restructure its external debt in a manner that minimizes costly litigation, improves debt sustainability, and gives the Republic time to deal with other pressing economic and humanitarian issues.

This paper only tackles the restructuring of Venezuela’s external bond indebtedness (“external debt”), which amounts to approximately \$65 billion.⁴ We do not propose a plan for dealing with the Republic’s remaining External Obligations, which include bilateral loans or arbitral awards and collectively exceed \$100 billion. The reason for the focus on external debt is twofold. First, external debt restructuring is more amenable to legal strategies, as the debt contracts are readily available and contain provisions that make a restructuring possible. The same cannot be said for other External Obligations, such as bilateral loans, as restructuring those would predominantly be a diplomatic rather than a legal exercise. Second, and more importantly, failing to restructure external debt – which is primarily held by powerful hedge funds – might decrease Venezuela’s bargaining power in “restructuring” all its other external obligations, as

1. Ben Bartestein & Christine Jenkins, *Venezuelan Bonds Get Harder to Trade Thanks to Sanctions Debts*, BLOOMBERG (Aug. 31, 2017), <https://www.bloomberg.com/news/articles/2017-08-31/venezuelan-bonds-get-harder-to-trade-as-sanctions-spur-caution>.

2. Robin Wigglesworth & Gregory Meyer, *Storm Harvey Adds to Headwinds for Venezuela Bonds*, FINANCIAL TIMES (Aug. 30, 2017), <https://www.ft.com/content/dc547820-8d8d-11e7-9084-d0c17942ba93>.

3. See, e.g., Lee C. Buchheit & Mitu G. Gulati, *How to Restructure Venezuelan Debt* (July 21, 2017), Duke Law Sch. Pub. Law & Legal Theory Series No. 2017-52, <https://ssrn.com/abstract=3006680> [hereinafter *How to Restructure Venezuelan Debt*]; Memorandum from Citi Research - Citigroup Global Markets “Venezuela Credit Strategy View: Estimating the recovery value in case of restructuring” (Aug. 8, 2017)(on file with authors).

4. See Mark Walker & Richard J. Cooper, *Venezuela’s Restructuring: A Realistic Framework 3* (Sept. 19, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3039678.

other creditors are unlikely to be willing to effectively subsidize the full payment of “vulture” funds.⁵

We propose that Venezuela restructure both PDVSA debt and its own external debt by encouraging bondholders to participate in Exchange Offers,⁶ which means that bondholders would agree to exchange their existing bonds for new bonds of reduced net present value (“NPV”).⁷ The success of the restructuring will be determined by the number of participating bondholders. Simply put, if not enough bondholders choose to participate by exchanging their bonds, Venezuela will not get the required debt relief. Minimizing the number of non-participating (“holdout”) creditors is thus a priority. While a sovereign has several strategic options to minimize holdout creditors in an exchange offer,⁸ we suggest that Venezuela use a *debt subordination* technique that can effectively serve the dual role of carrot and stick for creditors deciding whether or not to exchange their bonds. In this context, the technique requires the subordination of non-exchanged debt to exchanged debt, and we believe it to be the optimal strategy for encouraging broad creditor participation in the restructuring. Other restructuring options, such as the use of exit consents⁹ (recently proposed by Lee Buchheit and Mitu Gulati)¹⁰ and Collective Action Clauses¹¹ (“CACs”), remain available but should be

5. “Vulture” funds are hedge funds that specialize in buying debt of distressed sovereigns at a heavily discounted price and then using various methods to retrieve the debt’s full value. Vulture funds now likely hold increasing amounts of Venezuelan debt. See Landon Thomas Jr., *Venezuelan Debt Now Has the Vultures Circling*, N.Y. TIMES (Nov. 14, 2017), https://www.nytimes.com/2017/11/14/business/venezuela-debt-investors.html?rref=collection%2Fbyline%2Flandon-thomas-jr.&action=click&contentCollection=undefined®ion=stream&module=stream_unit&version=latest&contentPlacement=2&pgtype=collection&_r.

6. The paper assumes that a restructuring will be attempted when sanctions, which prohibit transactions in Venezuelan debt (i.e. issuance of new debt), have either been removed or modified to allow a traditional Exchange Offer.

7. The NPV reduction is necessary to lower the debt burden to a sustainable level, and it could come either from reducing the bonds’ principal amount or from reducing their interest rate and extending their maturities.

8. See Lee C. Bucheit & Elena L. Daly, *Minimizing Holdout Creditors: Carrots*, in SOVEREIGN DEBT MANAGEMENT 3, 8 (Oxford University Press ed., 2013) (explaining that a sovereign can frighten, deter, bind, or incentivize potential holdouts by using different legal techniques).

9. “Exit consent” is a technique that allows bondholders to exchange current bonds for new ones and, in the process of exchanging (‘exiting’), vote via a qualified majority (usually 51% or 66.67%) to strip the current bonds of important non-payment protections that would then bind all remaining non-exchanging bondholders holding those bonds.

10. See generally *How to Restructure Venezuelan Debt*, *supra* note 5.

11. CACs in bond contracts allow a supermajority (usually 75%) of bondholders to amend certain terms of the contract referred to as “Reserved Matters” (e.g. payment terms), binding all bondholders.

viewed as second-best options. As we explain, our strategy fills important gaps that other proposals have not addressed. For this reason, those other options should be viewed as supplementary techniques rather than primary restructuring mechanisms.

To use the debt subordination technique effectively, we recommend that Venezuela utilize the *pari passu* provisions included in approximately 90% of PDVSA's and Venezuela's bonds that can be read to allow for subordination of those bonds by Venezuelan law. A typical *pari passu* provision has been traditionally understood to protect creditors *against* legal subordination of outstanding unsecured debt.¹² This means that a debtor cannot treat existing or future unsecured debt as legally senior to any existing debt that includes the typical *pari passu* provision.¹³ The infamous *pari passu* provision in Argentina's bonds was effectively a longer variant of this "typical" provision.¹⁴ But New York courts in the Argentine litigation interpreted *pari passu* as protecting creditors from both legal subordination of their bonds *and* from non-ratable payment (*de facto* subordination) in the event of a default.¹⁵ This meant that a defaulting sovereign, such as Argentina, could neither legally subordinate existing debt, nor practically pay one creditor (i.e. exchanging bondholder) without concurrently paying another (i.e. holdout). The "ratable payments" interpretation therefore inhibits sovereign restructurings by severely discouraging creditor participation in Exchange Offers, since a rational creditor would choose to hold out and receive full payment rather than exchange and receive reduced payment. While more recent New York District Court decisions have arguably weakened this novel interpretation,¹⁶

The difference with 'exit consents' is that the latter requires a smaller qualified majority to amend contractual terms, and the amendable terms are the non-payment terms.

12. Lee C. Buchheit & Jeremiah S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, 53 EMORY L.J. 869, 911–12 (2004). The Latin term *pari passu* literally translates to "in equal step" and a typical *pari passu* provision would state that "the Notes rank, and will rank, *pari passu* in right of payment with all other present and future unsecured and unsubordinated External Indebtedness of the Issuer." *Id.* at 871.

13. Legal seniority of debt means that one creditor has a more senior legal right to payment than other creditors in the event of a default.

14. *See* NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 249, 251 (2d Cir. 2012) ("The Securities [bonds] will constitute . . . direct, unconditional, unsecured and unsubordinated obligations of the Republic and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Securities shall at all times rank at least equally with all its other present and future unsecured and unsubordinated External Indebtedness")

15. It was specifically the second part of the Argentine clause that gave rise to the "ratable payments" interpretation.

16. *See* White Hawthorne, LLC v. Republic of Argentina, No. 16-cv-1042, 2016 WL 7441699 (S.D.N.Y. Dec. 22, 2016); *Ajdlar v. Province of Mendoza*, No. 17-CV-1530, 2017 U.S. Dist. LEXIS

there is still a risk that Venezuela's *pari passu* clauses might be interpreted in line with Argentina's. For this reason, many experts suggest that architects of Venezuela's restructuring should use legal mechanisms to remove *pari passu* clauses from the bond contracts governing the restructuring in order to remove this risk.¹⁷

In contrast with experts that would remove *pari passu* clauses, we believe that the *pari passu* clause should be retained in both PDVSA and Venezuela bonds. In fact, we argue that Venezuela could and should use its *pari passu* provisions as a powerful tool *against* holdouts. This is because both the PDVSA and Venezuela *pari passu* provisions have been *modified* from a "typical" (e.g. Argentinian) clause, in a way that would arguably facilitate rather than impede Venezuela's restructuring efforts. The modified versions, copied in full in Part II (A) and Part III, include a qualification that seems to expressly allow existing debt obligations to be subordinated vis-à-vis other obligations identified by Venezuelan law. Thus, we suggest that Venezuela enact – or threaten to enact – a law that identifies *exchanged debt* as an obligation that would enjoy priority status vis-à-vis *non-exchanged* debt. This would offer bondholders a "carrot" in the form of priority payment if they choose to exchange, and a "stick" in the form of subordinated payment (which might effectively mean non-payment) if they choose to holdout.

It should be noted that this technique is not without risks. The particular *pari passu* language in Venezuela's bonds has never been tested in court. Further, the debt subordination would have to be retroactive in order to work, which could potentially give rise to claims of expropriation. Nevertheless, we find that New York contract interpretation principles, coupled with evidence from bond market pricing, support our interpretation of the modified clause. Also, Venezuela has plausible defenses to counter any claims of retroactive expropriation. Importantly, the success of this plan does not depend on the actual ability of the current or future

122659 (S.D.N.Y. Aug. 2, 2017). These decisions are not yet precedential, but are likely to be persuasive in any future adjudication by a New York court. According to the court in these cases, mere non-payment of bondholders, without some other "extraordinary act" by the debtor, was not sufficient to constitute contractual breach of the *pari passu* provision. In other words, the court tried to limit the "ratable payments" interpretation of the *pari passu* provision endorsed by the court in *NML v. Argentina*. According to the court, an example of an "extraordinary act" would be Argentina's passing of the "Lock Law," which effectively prohibited any and all future payments to holdouts.

17. See *How to Restructure Venezuelan Debt*, *supra* note 5, at 7; Walker & Cooper, *supra* note 6, at 25; Ricardo Haussman & Mark Walker, *Restructuring Debt in the Dark*, PROJECT SYNDICATE (Oct. 6, 2016), <https://www.project-syndicate.org/commentary/debt-restructuring-perils-for-venezuela-by-ricardo-hausmann-and-mark-walker-2-2016-10?barrier=accessreg> [hereinafter *Restructuring Debt in the Dark*].

government to formally adopt the suggested law; it suffices if creditors merely *perceive* the government as willing and able to pass the legislation at any point in time.

Our analysis proceeds in three parts. Part I assesses the key challenges to restructuring Venezuelan debt and argues that these challenges can be mitigated. Part II and Part III explain our specific proposals for restructuring PDVSA and Venezuelan debt, respectively, and discuss the anticipated legal risks associated with each.

II. VENEZUELA'S RESTRUCTURING: NECESSARY, COMPLEX, BUT FEASIBLE

Information on the economic conditions in Venezuela is limited and often inconsistent.¹⁸ The only certainty is that the Venezuelan economy has taken a significant hit from the global decrease in the price of oil. While the crisis was precipitated by an oil price decrease, however, the crisis is neither wholly exogenous nor temporary. In other words, this is not a liquidity crisis.¹⁹ To the contrary, the crisis is arguably structural because it is linked to the unproductivity of the oil sector, and to the economic distortions created by domestic price and currency controls.²⁰ It is for these reasons that markets have perceived the Venezuelan economy and PDVSA to be on the brink of insolvency, and a restructuring appears inevitable.²¹

Restructuring Venezuela's external debt would be a particularly complex endeavor. Thus, we must account for several potential challenges to the restructuring. These include (1) the heterogeneity of the debt structure; (2) the fact that most of the external debt is likely held by creditors who, in light of the outcome of the *NML v. Argentina* litigation,²² may have a higher propensity to hold out and litigate rather than

18. For instance, inflation rates and other key economic variables are reported differently in different sources.

19. Dany Bahar & Sebastian Strauss, *The Future of Venezuela: Are Reforms Enough to Guarantee Solvency?* THE BROOKINGS INSTITUTE, (Nov. 2, 2016), <https://www.brookings.edu/blog/up-front/2016/11/02/the-future-of-venezuela-are-reforms-enough-to-guarantee-solvency/>

20. *Id.*

21. According to recent data, the probability of default by PDVSA over the next 12 months is 92.7% (up from 50% in April). Ralph Cope, *Venezuela Default Probability Reaches Record in Bloomberg Model*, BLOOMBERG: PROFESSIONAL SERVICES. (June 28, 2017), <https://www.bloomberg.com/professional/blog/venezuelan-default-probability-reaches-record-bloomberg-model>. The probability of a credit event for Venezuela or PDVSA over the next 5 years is 99%. Ben Bartenstein, *White House Sanctions May Scare-Off Venezuela Vulture Investors*, BLOOMBERG (Aug. 28, 2017, 4:00 AM), <https://www.bloomberg.com/news/articles/2017-08-28/white-house-sanctions-may-scare-off-venezuela-vulture-investors>.

22. See generally *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 249 (2d Cir. 2012).

restructure; and (3) the fact that Venezuela has extensive contracts and assets abroad that could potentially be seized by holdout creditors who might still be entitled to full payment after restructuring efforts have concluded.

First, the overarching challenge is that the legal structure of the debt is heterogeneous, as the legal terms relevant to restructuring vary across PDVSA's and Venezuela's bonds. Specifically, PDVSA debt (approximately \$27 billion)²³ is issued under a trust indenture and does not contain any CACs that would allow modification of some key terms of the indenture ("Reserved Matters," such as payment terms) by a bondholder supermajority. Amendments to those matters instead require unanimous consent. Venezuela's debt (totaling approximately \$37 billion),²⁴ on the other hand, is divided into three categories with respect to CACs: (1) pre-2003 issued debt that contains no CACs and thus requires unanimous consent for amendments to "Reserved Matters", (2) 2003-2004 issued debt, with an 85% threshold for amendments, and (3) post-2004 issued debt with a 75% threshold to amend "Reserved Matters". In addition, PDVSA bonds require a simple majority to amend non-Reserved Matters, while Venezuela debt requires a 66.67% majority to make such amendments. Importantly, these voting thresholds need to be reached on a series-by-series basis (i.e. reached on each series of issued debt) rather than on an aggregate basis (i.e. reached by tallying the votes of all debt-holders).

A second challenge, which is unique to restructuring Venezuela's bonds containing CACs, and has been overlooked by some commentators,²⁵ is that even amendments to certain non-payment terms require a qualified 75% or 85% supermajority. Such terms include: sovereign immunity, jurisdiction, governing law, and place of payment. In other words, the scope of the "Reserved Matters" has been extended in Venezuela CAC bonds to include several important terms beyond the payment terms. This may restrict the scope of exit consent use – a technique that, as explained, allows a qualified majority of bondholders to amend certain non-payment terms in the bonds upon deciding to exchange them, binding all remaining non-exchanging bondholders. Therefore, Venezuela's restructuring is challenging because of non-uniformity in both the voting thresholds across the bonds needed for amendments, and the terms that these voting thresholds can amend. This debt heterogeneity

23. Walker & Cooper, *supra* note 6, at 3.

24. *Id.*

25. *Id.* at 25.

means that one might be unable to approach the entirety of the debt with a one-size-fits-all restructuring strategy.

But more generally, relying on reaching particular majority thresholds to effectuate a restructuring is problematic whenever holdout creditors are able to buy additional outstanding debt to prevent the majority threshold from being reached (i.e. become holders of at least 26% of a debt series to prevent a 75% CAC). Holdout buying of such “blocking” positions can effectively prevent the use of any threshold-based restructuring strategy. This problem is particularly acute when CACs and exit consents operate on a series-by-series rather than aggregate basis, as it is relatively cheaper for a holdout to buy a blocking position.

Third, the fact that Venezuela has extensive assets abroad presents a distinct challenge. Holdout bondholders may try to convince a court that, even though they chose not to exchange, they still have an enforceable right to full payment under their existing bonds. Venezuela's foreign assets would be the number one potential source of such payment, and any restructuring technique that leaves holdout creditors entitled to timely and full payment gives rise to ownership claims over those assets.

While each of these three challenges make a restructuring complicated, they are certainly not debilitating. Both PDVSA and Venezuelan debt contain modified *pari passu* provisions that can be read to permit changes in the ranking of payment obligations via Venezuelan legislation. Using *pari passu* could significantly mitigate the above challenges in at least three ways.

First, while the debt is otherwise heterogeneous with regard to contract terms, the same *pari passu* provision is included in all PDVSA bonds *and* in the vast majority of Venezuela bonds (all Venezuelan bonds except for non-CAC bonds). Successfully using our *pari passu*-based subordination strategy could therefore help restructure most of Venezuela's external debt (approximately 90%), and would require deferring to other techniques to restructure only a minority (approximately 10%) of outstanding debt.²⁶ Second, this technique virtually entirely avoids the challenge presented by holdouts buying blocking positions. While holdouts would only have to buy a fraction of PDVSA or Venezuelan debt in order to block the application of exit consents or CACs, they would have to buy 100% of the *entire* debt to avoid the subordination of their claims under our

26. The outstanding debt amounts to approximately \$64 billion. Non-CAC debt amounts to approximately \$6 billion. As *only* non-CAC debt does *not* contain the modified *pari passu* provision, this means that the provision can be used to restructure approximately 90% of the outstanding external debt.

approach. The fact that it only takes a few creditors of *any* debt-series exchanging their bonds to subordinate the claims of *all* holdouts makes the subordination approach particularly appealing. Third, the fact that non-exchanged debt could be subordinated to exchanged debt under Venezuelan law means that holdouts would no longer have a residual right to payment equal to that of exchanging bondholders. Therefore, they would not have an immediate right to any Venezuelan and/or PDVSA assets given that their right to payment would be secondary to the payment right of exchanging bondholders. Therefore, until all exchanging bondholders are paid, foreign assets would be safe from destabilizing holdout seizures.

In attempting to use the *pari passu* provision in its favor, Venezuela may benefit from the precedent established by Argentina's debt restructuring adjudication in *NML v. Argentina*²⁷ in at least two ways. First, even though the language of the *pari passu* provision in Venezuela's bonds is different than in Argentina's, the court's interpretation of the clause is beneficial to our approach. In *NML v. Argentina*, the court focused on the specific contractual language and concluded that all parts of the clause should be given effect whenever possible.²⁸ This is of paramount importance because, as explained, the clauses at issue here include a qualification that the debt can be subordinated according to Venezuelan law. Under the *NML v. Argentina* interpretative precedent, this qualification is a part of the clause that cannot be disregarded and must be given effect. Second, Argentina's holdout creditors convinced the court to adopt their "ratable payments" interpretation of the clause. In other words, Argentina's holdouts persuaded the court that they had *read* the clause and *understood* it as ensuring "ratable payments" when buying Argentina's debt. Given that the sovereign debt market has relatively few, but repeat, players, Venezuela's potential holdout creditors may reasonably overlap with Argentina's. In that case, it would be difficult for Venezuela's holdout creditors to argue that they did not contract with Venezuela with the particular modified clause in mind, since they had so carefully contemplated the meaning of the clause in Argentina's bonds. Similarly, Venezuela would have a strong case that the creditors must have taken the clause into account when purchasing the bonds and, as a result, the clause simply allocates the risk of debt subordination to creditors.

27. Argentina's famous debt restructuring litigation spanned a period of over 10 years, after the country defaulted on its debt in 2001 and attempted to restructure in 2005 and 2010. *See generally* Lee C. Buchheit & Mitu Gulati, *Restructuring Sovereign Debt After NML v. Argentina*, *Cap. Mkts. L. J.* vol 12, no. 2, 224.

28. *NML Capital, Ltd. v. Republic of Argentina*, 669 F.3d 249, 258–59 (2d Cir. 2012).

More recent court decisions on debt restructuring may also be beneficial for Venezuela. Specifically, the Second Circuit's decision in *Marblegate Asset Mgmt., LLC v. Educ. Mgmt., Corp.* extended the scope of the use of exit consents,²⁹ providing debtors in distress like Venezuela greater flexibility in utilizing this technique when needed. Thus, while using exit consents might not be effective as a primary strategy, this leaves room for their use as a supplementary option.

Having discussed some important ways in which Venezuela could mitigate the challenges in restructuring its debt, we now proceed with our specific proposals for restructuring PDVSA and Venezuelan debt.

III. PDVSA DEBT RESTRUCTURING: SUBORDINATION OF NON-EXCHANGED DEBT

A. Applicable Contractual Provisions

PDVSA bonds are notable for the general uniformity of their key provisions. Specifically, all PDVSA bonds lack CACs, include a simple majority threshold for amending non-payment terms, and incorporate a *pari passu* provision that states:

The Notes and the Guaranty will be the unsecured, senior obligations of the Issuer and the Guarantor and will rank *pari passu* with all other senior unsecured obligations of the Issuer and the Guarantor, *in each case other than obligations granted preferential treatment pursuant to the laws of Venezuela.*³⁰

In addition, the "Risk Factors Relating to the Notes" restate the provision:

The Notes will be our senior unsecured obligations. The payment of principal and interest on the Notes will be effectively subordinated in right of payment to all of our secured indebtedness *and to creditors given a statutory priority under applicable law*³¹

B. Strategic Use of *Pari Passu*

The *pari passu* provision in the bonds leaves open the opportunity to use Venezuelan law in the restructuring. In our view, use of this provision may suffice to instill a credible fear among potential holdouts that if they do not participate in a restructuring and tender their bonds, their bonds will be subordinated and they may be left virtually unpaid. Importantly, if this

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

30. Prospectus, PDVSA Senior Notes, 12.75% Due 2022 (emphasis added).

31. *Id.* (emphasis added).

fear is viewed as legitimate in a post-*NML v. Argentina* paradigm, PDVSA/Venezuela may not need other costly means of incentivizing creditors to effectuate a restructuring, such as stripping PDVSA of its right to exploit oil,³² or forcing PDVSA into bankruptcy.³³ Moreover, PDVSA would not need to aggressively use exit consents to achieve a successful restructuring.³⁴

In fact, solely using exit consents may prove insufficient for two reasons. First, and most importantly, the technique can be blocked if holdouts purchase 51% of *any* debt series, which is the majority threshold needed for using an exit consent strategy. Second, the technique might not guard against the possibility of holdouts seizing PDVSA assets. As discussed in Part I, holdouts could attempt to seize PDVSA/Venezuelan assets as a means of receiving full and timely payment. This is likely because, absent our legislative debt subordination solution, holdouts would still have a right to payment equal to that of exchanging bondholders – since exchanged notes would not qualify as “*obligations granted preferential treatment according to the laws of Venezuela*.”³⁵ Exit consents alone are unlikely to mitigate this problem because an exit consent strategy may not be used to remove the *pari passu* clause, which, without legislative intervention, ensures the debts’ equal ranking. The terms of the bonds would likely prohibit the removal of the clause without unanimous bondholder consent.³⁶ The only exit consent use that could be effective in minimizing the risk of asset-seizures is one that would allow a majority of bondholders to change the notes’ “Obligor;” a suggestion set forth by Lee Buchheit and Mitu Gulati.³⁷ Changing the Obligor (the entity carrying the obligation to pay the debt) from PDVSA to a new entity means that any holdout can only pursue the new entity’s assets for recovery. While this

32. See *Restructuring Debt in the Dark*, *supra* note 19. Asset stripping can however be seen as a way for the government to “intentionally bleed” the company for governmental gain, which creditors can use to pierce the veil between the government and PDVSA and seize Venezuelan assets.

33. See generally Walker & Cooper, *supra* note 6 (detailing this bankruptcy proposal).

34. A few experts have advocated for this approach. See e.g., *How to Restructure Venezuelan Debt*, *supra* note 5; Walker & Cooper, *supra* note 6.

35. Prospectus, PDVSA Senior Notes, 12.75% Due 2022.

36. PDVSA bonds state in relevant part that “no amendment may subordinate the Notes in right of payment to any other Indebtedness of the Issuer” and “no amendment may impair 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 . . .” See, e.g., *id.* at 111. Using exit consents to remove the clause entirely would likely be in breach of at least the second of the two above provisions.

37. See *How to Restructure Venezuelan Debt*, *supra* note 5, at 7–11.

technique would likely be effective in containing the asset-seizure risk,³⁸ it can do nothing to address the risk of holdouts buying a controlling position and blocking the application of the technique altogether. Invoking the *pari passu* provision and proceeding with a debt subordination strategy may therefore prove invaluable, if not necessary, for PDVSA's successful restructuring.

To make the provision work in Venezuela's favor, the Venezuelan government could pass a statute that subordinates non-exchanged debt to exchanged debt. In other words, exchanging creditors would receive statutory priority and preferential treatment (*vis-à-vis* potential holdouts) under Venezuelan law. Venezuela could announce the new law either before or after an Exchange Offer has been announced. If introduced before an Exchange Offer, the law would ensure that in the case of a future debt restructuring (1) initiated by the state (or state-owned entities) (2) with regards to specific debt series, and (3) executed via Exchange Offers, non-exchanged external debt would be subordinated to exchanged debt. Creditors would therefore be entering the exchange negotiations with the law already in place. If introduced when an Exchange Offer is already underway, the law may not have to be formally enacted at all, as long as the Exchange Offer prospectus clearly articulates the *possibility* of the legislative subordination of non-exchanged debt.³⁹ We believe it is preferable to commence an Exchange Offer before introducing a statute regarding debt subordination. Enacting a law before the commencement of an Exchange Offer may simply lead bondholders to sell their bonds to vulture funds that are more likely to hold out and resort to litigation rather than exchange. Regardless of the relative timing of the statute's potential enactment and Exchange Offer, however, the fear of non-payment to holdouts would be credible. The cautionary language in the Exchange Offer prospectus could hypothetically read as follows:

PDVSA does not foresee that it will have the resources to pay non-Exchanged Notes under their existing terms. In addition, and as explicitly provided in the terms of the existing Notes, the Exchanged Notes may be given statutory priority and enjoy preferential treatment in right of payment *vis-à-vis* Non-Exchanged Notes according to Venezuelan legislation.

38. This assumes that the new entity is structured in a way that legally and effectively separates it from PDVSA. Otherwise, creditors of this new company may attempt to seize PDVSA assets by "piercing the corporate veil," convincing a court that PDVSA and the new entity are not sufficiently distinct to warrant legal separation of obligations.

39. This possibility would be introduced as a risk in a hypothetical bond prospectus section titled "Risks of Not Participating in the Offer."

This language sufficiently warns that non-exchanged notes may remain in default, but also leaves room for PDVSA and Venezuela to pay holdouts if the holdouts are few enough that paying them would be more cost-effective than litigating against them.

We must note that the success of this plan does not depend on the ability of the current or any future government to formally pass the required law. It will certainly suffice if creditors merely *perceive* the government as willing and able to pass the legislation at any given point in time.

C. Additional Incentives to Participate: “Carrots and Sticks”

If PDVSA does not think that threatening to subordinate holdout debt alone would be sufficient to maximize creditor participation, it can proceed with the following supplementary options.

First, PDVSA could incentivize bondholders to accept the new bonds issued in the Exchange Offer by making them contractually attractive. For example, one such incentive could be the inclusion of a typical *pari passu* provision instead of a modified one, which would exclude the possibility of subordination according to Venezuelan law and make those new bonds harder to restructure. Another monetary incentive would be the inclusion of oil warrants in the new bonds that would guarantee payment to bondholders (in addition to coupons) if and when the oil market rebounds.

Second, PDVSA could utilize exit consents. This means that, as a condition for exchanging their bonds, 51% of bondholders would have to consent to amending certain non-payment terms of the old bonds when they exchange them. To the extent that these terms are sufficiently valuable, bondholders would rather hold new bonds of reduced NPV instead of old bonds of full value but amended contractual terms. One term that has been suggested as amenable to change is that of the Obligor, as mentioned earlier. Indeed, Lee Buchheit and Mitu Gulati suggest that delegating the debt obligations of PDVSA to a new and less trustworthy entity is contractually permissible and the best use of the exit consent strategy in this context.⁴⁰ Another term that could be changed is the place of payment. Changing the place of payment from New York to Venezuela would induce potential holdouts to exchange because Venezuela currently has strict capital controls that would make it harder for would-be-holdouts to expatriate their bond payments.

40. See *How to Restructure Venezuelan Debt*, *supra* note 5, at 7.

But as noted, an exit consent strategy would ideally come *after* a debt subordination strategy, and only if necessary. We find it likely that exit consents would not be needed if the subordination of the bonds were to be considered legally viable at the time of the Exchange Offer. In the past, bond subordination threats have successfully worked to incentivize bondholders to exchange their bonds. For instance, Argentina did not use exit consents in its debt restructuring. Instead, Argentina passed the “Lock Law,” a variant of our contemplated Venezuelan law, halting payments to non-exchanging bondholders. As a result of the law, 93% of bondholders chose to exchange. Since the contemplated use of a similar law here is more legitimate than in the case of Argentina – as the possibility of such law being passed is implicitly recognized in PDVSA bonds’ *pari passu* provision – we anticipate that the level of creditor participation could match or exceed that of Argentina, thus minimizing the need for additional restructuring techniques.

D. Legal Risks, Challenges, and Defenses

Our restructuring proposal is not risk-free. Potential holdouts could bring legal challenges to the recommended subordination technique. These challenges would likely relate primarily to the proper interpretation and use of the *pari passu* provision, as well as to the retroactivity of subordination. We explain, however, why these challenges are surmountable. Further, we defend against challenges to the use of exit consents as described above.

1. Interpretation of Contractual Language

Our proposal risks having holdouts challenge Venezuela’s interpretation and use of the modified *pari passu* provision. Holdouts could argue that Venezuela’s interpretation is inconsistent with the original intent of the contracting parties and it should therefore be disregarded. In particular, they would try to argue that (1) the qualifying language included in the *pari passu* provision is either boilerplate language or a drafting error that does not reflect contractual intent; or (2) there are alternative interpretations that are more “creditor friendly” and do not allow non-exchanged debt to be subordinated to exchanged debt. Regardless of the strategy holdouts choose to use to try to discredit Venezuela’s interpretation, we believe that New York contract interpretation principles weigh in favor of Venezuela.

As a threshold matter, there is no case law or treatise interpreting this particular variant of the *pari passu* provision in a sovereign debt contract. While the fact that this particular language has not been tested in court is a

risk, it also means that our proposition is doctrinally possible. In fact, prominent academics believe that similar language supplementing other *pari passu* provisions entitles a sovereign to “forbid payment to holdout creditors.”⁴¹ But what is more important is that the parties to the contract are sophisticated, are likely repeat players in the market, and have agreed to the negotiated terms of the debt contract. The *pari passu* language itself makes clear that (1) there are PDVSA obligations that (2) can be given preferential treatment in terms of ranking (3) by Venezuela’s laws. These “obligations” reasonably include debt obligations, which must also be “senior” and “unsecured” (e.g. new exchanged notes).

When dealing with sophisticated parties and explicit contractual language, New York courts overwhelmingly give deference to the contractual language as the best indicator of intent.⁴² Therefore, the inclusion of the qualification should not be disregarded as “boilerplate” or “a drafting error,” but instead viewed as a risk allocation mechanism whereby bondholders bear the risk of having their debt subordinated to other Venezuelan obligations, including exchanged debt. The fact that the provision appeared in several parts of the offering document further reinforces the argument that bondholders assumed the risk of subordination after receiving sufficient disclosure.

In addition, if holdouts argue that the provision should be given a meaning *different* than Venezuela asserts, they would have to offer alternative interpretations for the kind of obligations that can receive legislative preference (in lieu of exchanged debt). The holdout would have to find an example of an obligation that would fall under the provision *and* be a “senior unsecured obligation of the issuer,” as the *pari passu*

41. See, e.g., Stephen Choi et. al., *Variation in Boilerplate: Rational Design or Random Mutation?* 9–10 (NYU Sch. of Law, Public Law Research Paper No. 16-34, 2017), <https://ssrn.com/abstract=2827189>. The authors argue that a “Mandatory Law” exception in *pari passu* clauses subjects the clause to application of mandatory local law, and allows a sovereign to change its local law to forbid the payment to holdout creditors.

42. See, e.g., *Ashwood Capital, Inc. v. OTG Mgt., Inc.*, 99 A.D.3d 1, 7 (2012) (“According to well-established rules of contract interpretation, ‘when parties set down their agreement in a clear, complete document, their writing should as a rule be enforced according to its terms’. We apply this rule with even greater force in commercial contracts negotiated at arm’s length by sophisticated, counseled businesspeople . . . We . . . concern ourselves ‘with what the parties intended, but only to the extent that they evidenced what they intended by what they wrote.’”); *Syncora Guar. Inc. v. EMC Mortg. Corp.*, No. 09 Civ. 3106 (S.D.N.Y., June 19, 2012) (citing *British Int’l. Ins. Co. Ltd. v. Seguros La Republica, S.A.*, 342 F.3d 78, 82 (2d Cir. 2003) (“When interpreting a written contract, the Court seeks ‘to give effect to the intention of the parties as expressed in the unequivocal language they have employed.’”); *Gary Friedrich Enterprises, LLC v. Marvel Characters, Inc.*, 716 F.3d 302, 313 (2d Cir. 2013) (“When interpreting a contract [under New York law], the ‘intention of the parties should control, and the best evidence of intent is the contract itself’”).

qualification only applies toward such obligations.⁴³ Even more challenging than offering a list of plausible alternative obligations, however, would be to argue that the list is exhaustive and excludes exchanged debt as an obligation that could receive statutory priority.

Holdouts could counter-argue that if the contract gave Venezuela the power to subordinate holdout debt, the risk would be reflected in the price of the bonds. However, in the case of PDVSA, empirical price observations may prove inconclusive. PDVSA bonds contain many legal terms that could have been priced into the contract. If, for instance, one expected the *pari passu* provision to make the bonds tradable at a discount, that price effect could have been counteracted by the fact that the bonds require unanimous consent to amend payment and other terms. The latter makes the bonds “safer” for investors and would, all other things being equal, make them trade at a premium. Any price effect of the *pari passu* provision would thus be nullified. To properly isolate the price effect of *pari passu*, an econometric analysis would have to control for every other legal term. That would require a large data set of PDVSA bonds that differ in their legal terms. But, as previously mentioned, PDVSA bonds are uniform in their legal structure, thus making empirical analyses difficult to conduct.

A further risk is that holdouts could draw a parallel between Venezuela's law and Argentina's “Lock Law.” In the latter case, the law effectively halted payments to all holdout creditors and was found to be in breach of the Argentine *pari passu* provision. The law was ultimately considered such an extraordinary and unwarranted measure that it justified an injunction by New York federal courts to induce full payment of holdout creditors. However, this would be a contextually false analogy. Put simply, Argentina's *pari passu* provision – unlike PDVSA/Venezuela's – did not include a qualification that all external debt ranks *pari passu unless* some obligations are granted preferential treatment by legislation. Thus, while Venezuela's law may resemble Argentina's, unlike Argentina, the law in Venezuela's case is wholly consistent with the *pari passu* language.

A third, albeit smaller, risk is a potential holdout argument that Venezuela breached an implied “duty of good faith” by using local law to subordinate non-exchanged debt, essentially coercing bondholders to exchange their bonds. But the fact that the *pari passu* provision contained a qualification regarding the applicability of Venezuelan law weakens such arguments. U.S. contract law (and New York law in particular) has

43. Recall that the provision states the “notes rank *pari passu* with all other senior unsecured obligations...other than [senior unsecured] obligations granted preferential treatment...” See Prospectus, PDVSA Senior Notes, 12.75% Due 2022.

generally held that a good faith duty cannot provide bondholders with rights inconsistent with a bond's express terms.⁴⁴ Generally, when the issuer acts according to a bond's express provisions, good faith claims are unavailable.⁴⁵ Given the unavailability of a good faith argument, holdouts cannot easily raise claims of coercion either, at least not the type of coercion that a court would likely find unacceptable.⁴⁶

2. Retroactive Subordination and Expropriation

Additional challenges to the proposed subordination technique may stem from its retroactive nature. Venezuela did not have a law at the time of issuance stipulating that future exchanged debt would enjoy statutory priority. Retroactive application of law could give rise to claims of expropriation.⁴⁷ But Venezuela can raise three defenses.

First, mere subordination of non-exchanged debt most likely does not constitute expropriation. Bondholders would theoretically receive their payment as resources become available in the case of default. This is not the same as a situation in which bondholders are told explicitly that they will never receive any payment – as was the case in Argentina – and see their property rights virtually extinguished. An expropriation claim also has to show that expropriation was discriminatory (here, as against foreign bondholders). Here, all non-exchanging bondholders will be treated the same, whether they are Venezuelan residents or foreigners, so there is no evidence of discrimination.

Second, if expropriation were found to have occurred, Venezuela could use the state action doctrine as a defense. The state action doctrine provides that U.S. courts “[w]ill not judge the validity of official acts of a

44. See *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1517 (S.D.N.Y. 1989) (“In contracts like bond indentures, an implied covenant [of good faith] . . . derives its substance directly from the language of the indenture and cannot give Bondholders any rights inconsistent with those set out in the indenture.”).

45. See William Bratton & Adam Levitin, *The New Bond Workouts* 95 (Institute for Law and Economics, University of Pennsylvania Law Sch., Research Paper No. 17-9, 2017), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=2734&context=faculty_scholarship; William Bratton & Mitu Gulati, *Sovereign Debt Reform and the Best Interest of Creditors*, 57 VAND. L. REV. 1, 66 (2004).

46. This follows because “coercion” in restructuring proceedings is usually based on a finding of a breach of duty of good faith. See generally Bratton & Gulati, *supra* note 47.

47. See generally Melissa A. Boudreau, *Restructuring Sovereign Debt Under Local Law: Are Retrofit Collective Action Clauses Expropriatory?*, 2 HARV. BUS. L. REV. ONLINE 164 (2012), <http://www.hblr.org/?p=2283> (last visited Nov. 18, 2017).

foreign government carried out within its territory.”⁴⁸ Creditors would most likely challenge this defense on the grounds that the Second Hickenlooper Amendment⁴⁹ limits the application of the state action doctrine in expropriation claims and actually compels U.S. courts to make a determination by invoking international law. However, while this may appear to suggest that expropriation claims are in fact within the purview of U.S. courts, the Hickenlooper Amendment has been applied very narrowly because decisions affecting U.S. foreign relations are typically left to the purview of the executive branch.⁵⁰ Granted, the defense of state action is used predominantly in U.S. court litigation. But if the expropriation claims are instead arbitrated, the defense would not carry the same weight in arbitration proceedings.

Third, a justification for passing legislation that is grounded in “public necessity” gives Venezuela an affirmative defense against expropriation claims in both courts and arbitration tribunals. With a view to the disastrous potential consequences of default, Venezuela could claim that its actions were warranted out of public necessity, a consideration that often outweighs any sovereign’s duty to creditors. In mounting this defense in court proceedings, Venezuela would have to persuade a U.S. court to seek guidance from international tribunals.⁵¹ International courts have ruled, most recently in the case of the Greek restructuring decided by the European Court of Human Rights, that consideration of public necessity overrides duties to creditors in times of emergency.⁵² Granted, seeking guidance from international tribunals does not *necessitate* the same outcome by a U.S. court. But coupled with other factors (such as the tendency for U.S. courts not to question the domestic laws of foreign countries during times of emergency), we believe that a U.S. court holding may be consistent with international decisions.

48. *Underhill v. Hernandez*, 168 U.S. 250, 252 (1897) (“Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of [a foreign government] done out within its own territory.”).

49. 22 U.S.C. § 2370(e)(2) (2012).

50. *See, e.g.,* *Compania de Gas de Nuevo Laredo S.A. v. Entex Inc.*, 686 F.2d 322, 327 (5th Cir. 1982) (finding that the Hickenlooper Amendment was only intended to apply to cases involving claims of title to American-owned property nationalized by a foreign government in violation of international law).

51. In resolving such disputes, U.S. courts are prone to rely on guidance from international law. *See, e.g.,* *West v. Multibanco Comermex, S.A.*, 807 F.2d 820, 831 n.10 (9th Cir. 1987) (finding it “appropriate to look to international law” to determine if a certain action constitutes a taking).

52. *See, e.g.,* *Olguín v. Republic of Paraguay*, ICSID Case No. ARB/98/5, Award (July 26, 2001), 18 ICSID REV. 160 (2003) (noting that the taking was justified because it occurred within the context of a broader financial crisis); *Mamatás and Others v. Greece*, 2016-Eur. Ct. H. R. 256.

Most importantly, even if all defenses fail and the bondholders are entitled to compensation, the typical remedy is for the bondholders to receive the fair market value of the expropriated property. The fair market value of most bonds in this case is already heavily discounted from their original value. Therefore, the small percentage of creditors who may choose to hold out and bring an expropriation claim would likely only get paid a fraction of the original value of the bonds. Ironically, holdouts who win an expropriation claim may end up receiving similar value for their bonds as bondholders who chose to exchange their bonds, especially if the new bonds' value reflects the heavily discounted market value of existing bonds.

3. Potential Challenges to Exit Consents

If an exit consent strategy is used, and exchanging bondholders amend the “Guarantor” or place of payment, holdout creditors may argue that the amendments breached the contract terms and/or were unduly coercive, leaving them no meaningful choice but to exchange. We believe that in either case, changing these terms through exit consents would not be viewed by a court as a breach of the terms of the agreement nor as unduly coercive. This is supported by the Second Circuit’s recent opinion in *Marblegate*, where the court examined how exit consents interact with the Trust Indenture Act (“TIA”) 316(b) language and held that contractual amendments impairing one’s *ability* to receive payment are permissible as long as they do not impair one’s *right* to receive payment.⁵³ Here, changing the Guarantor or place of payment may affect one’s *ability* to receive the payment on time, but not one’s *right*.

To make a determination of whether the amendments to the aforementioned terms were unduly coercive, a court may invoke the doctrine of the intercreditor duty of good faith. Case law is scattered when it comes to the application of good faith duties in restructuring contexts. A large part of it is found in 19th century cases, which are still good law and generally hold that bad faith actions are self-interested actions not in the

53. See generally *Marblegate Asset Mgmt., LLC v. Educ. Mgmt. Corp.*, 846 F.3d 1 (2d Cir. 2017). While not governed by the statute per se, the language in PDVSA bonds strictly follows the TIA language stating in relevant part that “[o]ther amendments of, modifications to and supplements to the Indenture and the Notes may be made with the consent of the Holders of a majority in principal amount of the then Outstanding Notes issued under the Indenture, except that, without the consent of each Holder affected thereby, no amendment may . . . impair 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.” Prospectus, PDVSA Senior Notes, 12.75% Due 2022, at 110–11.

best interests of the bondholders as a group. This would not include actions undertaken for self-preservation or otherwise for private gain.⁵⁴ Here, the act of the majority of exiting creditors to amend certain terms arguably qualifies as an act of self-preservation that will benefit bondholders as a group by preventing a minority of creditors from holding out and getting a disproportionate amount of available resources. More importantly, in more recent U.S. cases, courts have given effect to a good faith duty only when it arises directly from the language of the contract,⁵⁵ or when a party's actions go against the reasonable expectations of the bondholders.⁵⁶ The bond contracts here contain an exhaustive list that explicitly prohibits a variety of amendments without unanimous bondholder consent.⁵⁷ The fact that amending the place of payment or the Guarantor is *not* explicitly prohibited means that such amendments via a qualified majority would fall within the reasonable expectations of the parties. As a result, a court is unlikely to find that such an amendment violates a good faith duty and is thus unduly coercive.

IV. VENEZUELA'S EXTERNAL DEBT RESTRUCTURING

We recommend that Venezuela use a similar strategy to restructure its own debt. As noted at the outset, the vast majority of the outstanding Venezuelan bonds contain *pari passu* provisions that may allow for the subordination of those bonds according to local law. The exact provision states:

The Notes constitute Public External Indebtedness of the Republic and (subject to "Negative Pledge" below) are direct, unconditional, unsecured and general obligations of the Republic and shall at all times rank *pari passu* and without any preference among themselves. The payment obligations of the Republic under the Notes shall, *save for such exceptions as may be provided by applicable legislation* and subject to "Negative Pledge," at all times rank at least equally with all its other payment obligations relating to External Public Debt⁵⁸

This provision exists in all CAC bonds (the post-2003 bonds). However, non-CAC (pre-2003) bonds do not contain the exact provision and make no reference to applicable law. Non-CAC debt stock is

54. See Bratton & Levetin, *supra*, note 47, at 93; see also Hackettstown National Bank v. D.G. Yuengling Brewing Co., 74 F. 110, 112 (2d Cir. 1896).

55. Katz v. Oak Industries, 508 A.2d 873, 880–81 (Del. Ch. 1986).

56. Kass v. Eastern Airlines, 1986 WL 13008, at *1 (Del. Ch. 1986), *aff'd*, 518 A.2d. 983 (Del. 1986).

57. Prospectus, PDVSA Senior Notes, 12.75% Due 2022, at 110–11.

58. Prospectus, Venezuela Global Bonds, 13.625% Due 2018, at 16 [hereinafter Venezuela CAC Bond].

comprised of (1) a 1991-issued bond of \$1.6 billion;⁵⁹ (2) a 1997-issued bond of \$4 billion⁶⁰ and (3) a 1998 issue of \$750 million. These bonds contain the following provision that makes no reference to “applicable legislation”:

The Global Bonds will be direct, unsecured, general and unconditional obligations of Venezuela. The Global Bonds will rank *pari passu*, without any preference among themselves. The payment obligations of Venezuela under the Global Bonds will at all times rank at least equally with all other payment obligations of Venezuela relating to External Public Debt.⁶¹

Ideally, Venezuela would homogenize the debt by repurchasing the debt consisting of non-CAC bonds, especially if some issues are trading at a discount. But repurchasing debt would require sufficient liquid funds to cover the cost of the debt. Unless Venezuela could get emergency credit from outside creditors, it would be unlikely to have sufficient liquidity to engage in open market debt repurchasing. Thus, without outside credit, homogenizing the debt would be unlikely, and a restructuring plan would have to treat the two debt stocks differently.

A. Restructuring CAC-Bonds

1. First-Best Option: Legislative Subordination of Non-Exchanged Debt

The payment obligations of the Republic under the notes shall rank *pari passu* with all other external indebtedness, “save for such exceptions as may be provided by *applicable legislation*.”⁶² This means that Venezuela can amend the “applicable legislation” to subordinate future non-exchanged debt to exchanged debt. As in the case of PDVSA debt, this subordination can be actual or potential; in other words, Venezuela could enact the legislation before an Exchange Offer, or threaten to enact the legislation in the course of the Exchange Offer.

Using this subordination technique for the CAC-bonds is preferable to simply relying on the operation of the CAC or using exit consents, as both those techniques may prove ineffective. CAC bonds are not aggregated, which means that the 75% or 85% threshold for amending the payment terms has to be reached on a series-by-series basis. When the collective will of the bondholders is exercised on a series-by-series basis, however,

59. Prospectus, Venezuela Collateralized Floating Rate Bonds, 6.75% Due 2020.

60. Prospectus, Venezuela U.S. Dollar-Denominated Unsecured Global Bonds, 9.25% Due 2027

61. *Id.* at 73.

62. Venezuela CAC Bond, *supra* note 60.

financially powerful holdouts can block the application of a CAC by buying a sufficient amount of debt that makes them a supermajority debtholder.

If triggering the CAC proves impossible, the most viable remaining option, absent the legislative subordination solution, would be to use exit consents. Exit consents in CAC bonds would require the issuer to convince at least 66.67% of bondholders to exchange their bonds and agree to amend non-payment terms in the old bonds before they exit. But there are at least two problems with using exit consents. First, powerful holdouts who can block the operation of the CAC may also buy a blocking position to prevent the use of exit consents. Second, even if holdouts do not acquire a blocking position, exit consents would, on their own, likely be insufficient to induce participation. To recall, an exit consent strategy only allows bondholders to amend certain Non-Reserved Matters (matters that are not reserved for amendment by the CAC majority). But CAC bonds simply include too many terms as “Reserved Matters” that are amendable only via a supermajority. These include changes in the governing law, jurisdiction, immunity, currency, and even place of payment, thus leaving little room for using exit consents effectively.

Our proposed subordination technique mitigates these problems because it does not require convincing 66.67% or 75% of bondholders to exchange. In other words, a potential holdout is afraid of a 66.7% majority when confronted with the use of exit consents, and of a 75% or 85% majority when confronted with the use of a CAC. When confronted with the potential subordination of the bonds, however, the holdout is effectively afraid of even that 1% that may choose to exchange, which can come from any debt series. That is because it effectively only takes one bondholder to choose to exchange (and receive statutory priority) for the holdouts' debt to be subordinated. As discussed previously in the context of PDVSA, this means that holdouts would have to purchase the entire debt to eliminate the risk of debt subordination.

In the event that the subordination technique does not immediately induce 100% of bondholders to exchange – and even falls short of the Argentinian precedent of 93% participation – it is highly likely that it may still convince 75% or 85% of bondholders to exchange, triggering the CACs and binding all bondholders to the restructured payment terms. Therefore, while the CAC should not be the primary mechanism to restructure CAC bonds, we see that, if necessary, it could serve as a complementary mechanism to maximize participation.

Debt subordination here would only work if the term “applicable legislation” referred to Venezuelan law. Holdouts may argue that “applicable legislation” refers to New York rather than Venezuelan law, making the provision temporarily more ambiguous than the one in PDVSA bonds that explicitly refers to Venezuelan law. They would base their argument on the fact that New York law governs the contract, and hence that the term “applicable” refers to New York law. However, rules of contract interpretation, as well as common sense, weigh in favor of a finding that “applicable legislation” refers to Venezuelan, rather than New York, law. According to New York Courts, “it is a cardinal rule that a contract should not be read to render any provision superfluous,”⁶³ and a contract interpretation “that has the effect of rendering at least one clause superfluous or meaningless is not preferred and will be avoided if possible.”⁶⁴ The Second Circuit, in its contract interpretation of *pari passu*, also maintained “a contract should not be interpreted in such a way as would leave one of its provisions substantially without force or effect.”⁶⁵ In this case New York law governs the contract, which means that all provisions of the contract are, by default, given effect according to New York law. The *pari passu* provisions would still be subject to New York legislation as a default rule under the contract. Therefore, it would be superfluous to include the provision “*save for such exceptions as may be provided by applicable legislation*”⁶⁶ as a reference to New York law. Since contract provisions should not be interpreted in a way that they become superfluous, “applicable legislation” reasonably refers to Venezuelan, not New York, legislation.

Additionally, evidence from Venezuela bond market pricing supports our position that the provision refers to Venezuelan law. If the initial hypothesis of an empirical test was that “applicable legislation” refers to Venezuelan law, then one would expect to see, as here, Venezuelan bonds that include the specific modified *pari passu* language valued less than Venezuelan bonds without the language (such as pre-2003 bonds). This is because the ability to successfully hold out is lower, and the possibility of non-payment greater, when the modified *pari passu* clause is present.

63. *Reyes v. Metromedia Software, Inc.*, 840 F.Supp.2d 752, 756 (S.D.N.Y. 2012).

64. *LaSalle Bank Nat. Ass'n v. Nomura Asset Capital Corp.*, 424 F.3d 195, 206 (2d Cir. 2005).

65. *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 249, 258–59 (2d Cir. 2012).

66. *Venezuela CAC Bond*, *supra* note 60.

Indeed, a recent empirical paper on the pricing of Venezuelan bonds found the hypothesis to be true.⁶⁷

Finally, while holdouts could argue that the *pari passu* clause's language is simply boilerplate or that Venezuela has misinterpreted it, their contention would not hold significant weight. For one thing, there is little room for misinterpretation. The clause clearly states that there can be legislative exceptions to the equal ranking of obligations guaranteed by *pari passu*. And, there is no reason to believe that exchanged debt cannot be identified as one such exception. It would also be difficult to argue that the clause's modification is boilerplate language and not intended to be particularly meaningful, as pre-2003 bonds did *not* have any modifications from a typical clause, but post-2003 bonds did. As such, it becomes clear that Venezuela intentionally included the qualification or exception to *pari passu* in Venezuela's bonds after 2003, intending for it to be contractually meaningful.

2. Second-Best Option: Exit Consents Plus CACs

Exit consents could be used, but only *in conjunction* with the CAC. In other words, neither a standalone use of the CAC nor exit consents would be enough to incentivize bondholders to participate in an exchange. Using exit consents and CACs conjunctively is riskier than the legislative subordination technique set forth above, as a court is more likely to view it as coercive. It also presupposes that bondholders would not be able to buy blocking positions. We explain here how it could work if we make that assumption.

Venezuela would announce an Exchange Offer, under which holders of the old bonds would be encouraged to exchange them for new bonds. The payment terms of the new bonds would be altered to ensure a decreased NPV, by either cutting the principal amount, or extending the maturities and decreasing the interest rate. If, at the time of the proposed exchange, Venezuela deems it unlikely that 75% or 85% of bondholders will tender their bonds, the new bonds would include attractive terms ("carrots") in the hopes of having at least 66.67% of bondholders – the minimum percentage of bondholders required for use of exit consents – accept the exchange.⁶⁸ If 66.67% of bondholders decide to exchange,

67. While the difference in pricing may have also been a result of post-2003 bonds including CACs, the authors found that the *pari passu* provision also played a role in those bonds trading at a discount. See generally Elena Cartletti et al., *Pricing Contract Terms in a Crisis: Venezuelan Bonds in 2016*, 11 CAP. MKTS. L.J. 540 (2016).

68. Possible "carrots" could include premium payments, oil warrants, or *pari passu* provisions that do not allow for legislative subordination.

Venezuela would then use an exit consent strategy so that those bondholders could amend the terms of the old bonds *before* they exchanged them (i.e. before they are no longer bondholders of the old bonds).⁶⁹ In order to compel the additional 9% of bondholders needed to reach the 75% CAC threshold, bondholders would make the old bonds less attractive by amending the old bonds' non-payment terms, such as Events of Default and Acceleration provisions.⁷⁰ As a 75% supermajority, then, the exchanging bondholders would have to consent to amending the "Reserved Matters" of the old bonds, such as payment terms. In light of the outcome of a recent British case on exit consents,⁷¹ the bondholder supermajority would probably not extinguish the value of the old bonds. Instead, bondholders would likely agree to make the payment terms of the old bonds *identical* to the terms of the new bonds, effectively bypassing any significant coercion arguments. Hence, the bondholders who decided to holdout would be holding old bonds with identical NPV as the new bonds,⁷² as well as amended non-payment terms. Even if the holdouts would now own 100% of the old bonds post-exchange, no bondholder majority could re-amend the payment terms to increase the bond's value. They may be able to re-amend non-payment terms, but that would still leave them with bonds of the *same (reduced) value* as the new ones, minus the additional carrots that were included in the new offered bonds. As a result, it would be in their best interest to exchange rather than hold out.

B. Restructuring Venezuelan Non-CAC Bonds

Because the pre-2003 bonds do not include CACs and the bond provisions do not explicitly leave room for debt subordination by Venezuelan law, the best option for restructuring them is using a combination of "carrots" (incentives) and "sticks" (exit consents).

69. The exiting bondholders will have to consent to amend the Bond themselves before they exit, as well as transfer power of attorney to the government to vote on their behalf when they are no longer able to vote. Contractually this seems possible. See Lee Buchheit & Mitu Gulati, *How to Restructure Greek Debt* 9 (Duke Law Sch., Working Paper No. 47, 2010), <https://ssrn.com/abstract=1603304>.

70. These provisions define what events qualify as "default", and whether a creditor can demand immediate payment at that time.

71. See *Assenagon Asset Mgmt. S.A. v. Irish Bank Resolution Corp.*, [2012] EWHC 2090 (Ch) (Eng.) (finding that using exit consents in conjunction with the functioning of CACs was excessively coercive when it virtually extinguished the value of non-exchanged bonds, far below their market value).

72. In determining where to set the bonds NPV, bondholders can simply set it at the current market value of the bonds, which is already discounted compared to the bonds' original value.

1. “Carrots”: Oil and GDP Warrants

To incentivize bondholders to participate in the restructuring, we propose issuing bonds with oil and GDP warrants, which would allow bondholders to recover some of the bond value lost in the restructuring. Oil-linked bonds would guarantee payment to creditors if the oil market rebounds. Equivalently, GDP-linked bonds would yield higher returns for the bondholders throughout Venezuela's broader economic recovery. GDP warrants can be particularly valuable to investors because Venezuela's recovery will not only be a factor of rising oil prices, but will additionally depend on broader economic reforms. Therefore, coupling GDP and oil warrants ensures that creditors will adequately benefit from Venezuela's future economic recovery.

2. Exit Consents

In addition to incentivizing creditors to exchange, Venezuela could use mechanisms to deter creditors from holding out, such as exit consents. While Venezuela's CAC bonds contain provisions barring amendments to central provisions such as (i) the governing law, (ii) the ranking of the bonds (*pari passu* provision), and (iii) the waiver of immunity, the older non-CAC bonds do not include any such prohibitions; rather, they only prohibit amendments of payment terms and currency. Therefore, the non-CAC bonds at issue here would allow a broader and thus more effective use of exit consents.

V. CONCLUSION

Venezuela is confronting an unprecedented economic and financial crisis. A restructuring is inevitable, and will require an effective strategy to minimize costly litigation, improve debt sustainability, and free the Government to deal with other pressing economic and humanitarian issues facing the country. Given the heterogeneity of its debt stock, Venezuela's debt restructuring may prove to be a particularly complex affair. Recently proposed restructuring strategies that rely on exit consents and Collective Action Clauses may prove insufficient to encourage large creditor participation in a restructuring. That is because those strategies leave room for powerful holdouts to buy blocking positions to preclude the use of those strategies altogether, and may also make it possible for them to seize PDVSA's and Venezuela's assets abroad. Instead of using exit consents and Collective Action Clauses as a sole or primary strategy, we believe that utilizing the *pari passu* provision in PDVSA and Venezuela bonds is the optimal option. Because the provision can be read to allow for

subordination of the bonds according to Venezuelan law, Venezuela can threaten the enactment of a law that subordinates non-exchanged debt to exchanged debt, thus making timely payment of holdout creditors unlikely. We believe fear of non-payment will compel creditors to join the Exchange Offer rather than hold out, especially because a New York court would likely find that using this technique is contractually permissible. This proposal is appealing because it only requires a handful of creditors of any debt series to exchange their bonds in order to subordinate *all* holdout debt. Thus, Venezuela would not be concerned with reaching higher pre-determined thresholds of creditor participation to effectuate the restructuring. Further, since holdout debt would be subordinated, holdouts would not have a primary claim over Venezuela's or PDVSA's assets abroad, leaving those important assets available for payment of exchanging bondholders and other productive uses.