To: Minister of Finance of the Bolivarian Republic of Venezuela

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Subject: Restructuring Proposal for Venezuelan and PDVSA External Debt

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I. Introduction

"Black gold" is both a blessing and a curse. It has been the latter for Venezuela since 2014 when oil prices plummeted. Despite its large reserves,[1] Venezuela's production and export of crude oil has been steadily declining for the past two decades.[2] This trend is largely explained by the mismanagement of Petróleos de Venezuela, S.A. ("PDVSA"), Venezuela's state-owned oil and natural gas company, as well as plunging oil prices. In a country where oil revenues account for almost all export earnings and nearly half of the GDP,[3] the decline in oil production coupled with the drop in oil price has resulted in an economic turmoil.[4] These developments have inevitably caused the market to lose confidence in Venezuela and PDVSA's ability to sustain their debt burdens. Consequently, these circumstances prevent Venezuela and PDVSA from accessing external funding on reasonable terms.[5]

Two main factors contribute to the market's fear: (1) PDVSA's significant amount of social contributions,[6] preventing the necessary investments in the company's infrastructure

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[1] Proven oil reserves in Venezuela are recognized as the largest in the world, totaling 300.9 billion barrels as of the end of 2015 – *See* BP Statistical Review of World Energy (June 2016), http://www.bp.com/content/dam/bp/pdf/energy-economics/statistical-review-2016/bp-statistical-review-of-world-energy-2016-full-report.pdf.

[2] *Id.* Oil production in Venezuela decreased from 341.8 million tons in 2001 to 135.2 million tons in 2015

[3] *See* CIA, The World Factbook: Venezuela (April 19, 2017), https://www.cia.gov/library/publications/resources/the-world-factbook/geos/ve.html.

[4] *Id.* Venezuela ended 2015 with an estimated 10% contraction in its GDP and 275% inflation. The IMF estimates that in 2016 Venezuela's GDP would shrink another 8% and inflation would reach 720%.

[5] Both PDVSA's and Venezuela's debt are below investment grade, rendering the borrowing in capital markets extremely onerous.

[6] The National Fund for National Development (FONDEN) is a government owned entity funded by a tax on the international sale of hydrocarbons (the Windfall Oil Price Tax). In 2016, the Budget Law in Venezuela set up the following thresholds: (1) a 20% tax on exports if the price of a barrel is equal or less than $80; (2) an 80% tax on the surplus (actual price - $80 price) if the price of the barrel is greater than $80 but less than $100; (3) a 90% tax

(thus further slowing down the production of oil); and (2) PDVSA's inability to monetize Venezuela's crude oil, resulting in its inability to service PDVSA's and Venezuela's debt. In our view, these factors need to be addressed to restore the market's confidence so both PDVSA and Venezuela regain access to the capital markets.

To this end, a restructuring of both sovereign and corporate debt is necessary so that both entities have a chance at being able to service their future debt burdens, restoring market confidence and access to capital markets. Additionally, the improvement of Venezuela's debt to GDP ratio and PDVSA's debt to equity ratio would allow them to raise funds at an affordable interest rate. Our plan consists of a voluntary exchange of the existing notes against new notes bearing a reduced principal amount. Below is an outline of the legal instruments, which will (1) allow both PDVSA and Venezuela to induce the largest number of noteholders to participate in the restructuring and (2) provide protection against potential holdouts. The first part of the analysis will address PDVSA's debt and the second part will address Venezuela's sovereign notes.

II. Restructuring PDVSA's Debt

We recommend soliciting a voluntary exchange of the existing notes ("Existing PDVSA Notes") against new notes ("New PDVSA Notes") with a reduced principal amount. Since the Existing PDVSA Notes do not allow for a haircut without obtaining each noteholder's consent, we need to structure an exchange mechanism that attracts as many noteholders as possible and motivates them to accept the exchange despite the risk of certain holdouts interfering with the successful restructuring or by simply free-riding on the exchange.

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on the surplus if the price of the barrel is greater than $100 but less than $110; and (4) a 95% tax on the surplus if the price of the barrel is greater than $110. The Ministry of Economy is in charge of allocation of FONDEN's funds, however the use of the funds is extremely opaque. Sources report that FONDEN financed the acquisition of military equipment from Russia and the taking of participation in certain Russian entities in connection with the acquisition of equipment.

A. <u>Considerations in Restructuring PDVSA's Debt</u>

Existing PDVSA Notes do not contain collective action clauses ("CACs"). Therefore, any amendment to "core" provisions, such as the principal amount, interest rate, and due date of any payment under the Existing PDVSA Notes, requires the *unanimous* consent of all noteholders. On the other hand, Existing PDVSA Notes provide that the amendment of any provision, other than those specifically requiring unanimous consent, may be made with the consent of a majority of noteholders. Consequently, and except for amendments to certain limited "core" provisions, a threshold of 50%+1 will be required for most amendments in the Existing PDVSA Notes.

A portion of Existing PDVSA Notes[7] have already been exchanged for new notes with an extended maturity (the "Extended PDVSA Notes"), which are secured by a first-priority lien on over 50.1% of the capital stock of CITGO Holding, Inc. ("Collateral"). The release of the Collateral requires the consent of the noteholders of at least 66 2/3% in aggregate principal amount of the outstanding Extended PDVSA Notes.[8]

All Existing PDVSA Notes and Extended PDVSA Notes are guaranteed by PDVSA Petróleo S.A., a wholly owned subsidiary of PDVSA incorporated in Venezuela. The guaranty ranks equally with all existing and future senior unsecured obligations, except for those preferred by statute or by operation of law. The terms of the prospectuses pertaining to all Existing PDVSA Notes and Extended PDVSA Notes are quasi-identical; therefore, we assume that the main provisions of the respective indentures,[9] including but not limited to the terms of the guaranties,[10] should be identical.

[7] 5.250% Senior Notes due April 2017 and the 8.50% Senior Notes due November 2017.
[8] Petróleos De Venezuela, S.A., Pledge and Security Agreement (Form T-3), Exhibit T3E-1 at 20 (Sept. 27, 2016), https://www.sec.gov/Archives/edgar/data/906424/000119312516720824/d248237dex99t3e1.htm.
[9] *See* Petróleos De Venezuela, S.A., Indenture (Form T-3), Exhibit T3C, https://www.sec.gov/Archives/edgar/data/906424/000119312516712239/d171369dex99t3c.htm. All references to the term "Indenture" or "Indentures" in this memorandum should be read in conjunction with the available form of Indenture.
[10] *Id.* at 49.

B. Exchange Offer

It will be very unlikely to obtain the unanimous consent of the noteholders of both Existing PDVSA Notes and Extended PDVSA Notes. Therefore, we propose to solicit a voluntary exchange of the Existing PDVSA Notes and the Extended PDVSA Notes against New PDVSA Notes with a reduced principal, guaranteed by PDVSA Petróleo S.A. In order to provide noteholders with enough confidence in PDVSA's ability to service the debt and to attract the largest number to participate in the exchange offer, the following principles should guide the restructuring: (a) making a "sufficient"[11] reduction of principal, which would ensure a stable repayment of the restructured debt; (b) providing incentives by setting up a sinking fund and granting "upside sharing"[12] rights to consenting noteholders, which would mitigate their concerns about the restructuring being too generous to PDVSA (overly reducing the principal) to the detriment of the noteholders; and (c) introducing a mechanism[13] that would prevent PDVSA from being motivated to ignore the creditors' interests.

1. Incentives for Participating Noteholders

Our proposal would incentivize the noteholders to participate in the exchange by (a) enhancing the stability of future repayment of the restructured debt with sinking funds, which are also supposed to limit PDVSA's social contributions and boast creditor confidence; and by (b) allowing consenting noteholders to share in PDVSA's upside as described below.

[11] In this regard, PDVSA should seek to conform the aggregate amount of its debt to its capacity to repay based on the expected fluctuation of the oil price in a "worst case scenario."

[12] The New PDVSA Notes should be accompanied by the right for participating noteholders to receive additional money in case significant upside occurs much greater than the amount calculated based on the "worst case scenario."

[13] The noteholders and Venezuela's interests should be aligned by introducing an obligation for PDVSA to set aside for the benefit of noteholders a proportional amount of any PDVSA's distribution including dividend, buyback, contribution to social funds, abnormal taxes.

i. *Sinking Fund*

A sinking fund is designed to address risk-taking behavior by the issuer and was a popular creditor protection mechanism for much of the history of sovereign debt.[14] PDVSA should create a sinking fund in the form of either (a) a segregated bank account, to be pledged to secure the New PDVSA Notes or (b) a trust fund with the new PDVSA noteholders as the beneficiaries. Both should be set up in an investor friendly jurisdiction.[15] PDVSA must covenant to annually transfer money to the bank account/trust fund, the amount of which would be the aggregate sum of (i) a certain percentage of the after-tax profit of PDVSA[16] ("Reassurance Fund"); and (ii) a certain percentage of the "distribution" made by PDVSA for the benefit of Venezuela, like its social contributions, ("Deterrence Fund"). These funds should be used for the sole purpose of servicing the debt, unless the funds are released by a supermajority approval of the holders of the New PDVSA Notes. The Reassurance Fund would allow PDVSA, in substance, to pay back portions of the principal at the same time as the interest payments, as opposed to paying a large principal payment upon maturity, easing creditor concerns that they may not get their principal back.[17] The Deterrence Fund would prevent PDVSA from continuing to distribute money to "social projects" to the detriment of its creditors. It also would halt PDVSA and Venezuela from utilizing loopholes to siphon money from PDVSA, by providing a comprehensive definition of "distribution," including

[14] Though sinking funds have gone out of fashion, as "debtors increasingly relied on an increasingly robust bond market and hedging strategies." *See* Stephen J. Choi, Mitu Gulati and Eric A. Posner, POLITICAL RISK AND SOVEREIGN DEBT CONTRACTS, University of Chicago Public Law & Legal Theory Working Paper, No. 370 (2011).

[15] Such as the Cayman Islands or British Virgin Islands, but not in the U.S. because PDVSA would be afraid of possible asset freezes by the U.S. government.

[16] PDVSA is currently facing the zone of bankruptcy so it may not have sufficient free cash flow to transfer the reassurance fund. Therefore, it may be possible to structure the obligation starting after a certain grace period, so that Venezuela and PDVSA have ample time to recover from their current dire economic situation.

[17] This would put creditors' minds at ease that they will get paid back in full. This fund will also protect PDVSA from defaulting on its notes even if Venezuela faces political or financial shocks because it has set money aside in this fund solely for the notes. This is particularly applicable here based on Venezuela's current political climate, and the potential likelihood for future political upheaval and because of Venezuela's huge economic dependence on the price of oil.

dividend, share buyback, tax and other levy, social contribution, discount sale of products and whatever costs and expense incurred by PDVSA for the ultimate benefit of Venezuela.[18]

In order to exercise a significant psychological pressure on PDVSA to comply with these covenants, PDVSA should agree that a breach of these covenants constitutes a material default of the New PDVSA Notes. This would result not only in the acceleration of the New PDVSA Notes with the reduced principal, but also in the reverse exchange of New PDVSA Notes with the Existing PDVSA Notes held in in trust[19] (as discussed later), upon the vote of the required majority of noteholders. Another possible alternative to ensure PDVSA's compliance with these covenants would be to structure the sinking fund is structured as a trust, and convey some of PDVSA's current/future account receivables against the obligors outside Venezuela to the trust, and authorize the trustee to collect the receivables and distribute it to the noteholders, conditional upon PDVSA's failure to transfer the required amount of money when due (in the absence of such failure, the proceeds of the account receivables will flow back to PDVSA).[20]

Establishing a sinking fund will help to quell noteholders' concerns about PDVSA's future ability to service its debt.

ii. *Upside Sharing Mechanism*

Another way to incentivize noteholders' participation in the restructuring is to include in the New PDVSA Notes an upside sharing mechanism in the form of warrants or preferred shares in PDVSA. The payout on the warrants or preferred shares would be (a) proportionate to the "upside" from profit or free cash flow (calculated on "before distribution" basis using

[18] PDVSA's significant contribution to Venezuela's social programs, which has continued even after its financial conditions have neared insolvency, represents a serious concern to the noteholders. The creation of a Deterrence Fund will mitigate their fears that social contributions would impair PDVSA's ability to service its debt.
[19] This would undo the significant efforts made by PDVSA and Venezuela for the restructuring and therefore would highly motivate the compliance of the covenants by PDVSA.
[20] Similar to Peru's guano sinking fund. *See* Catalina Viscarra, Guano, CREDIBLE COMMITMENTS AND STATE FINANCES IN NINETEENTH-CENTURY PERU, 69 Journal of Economic History 358 (2009).

the same definition of "distribution" as discussed above) forecasted in the underlying scenario in determining the haircut amount, and (b) capped to the amount of the haircut granted by the noteholders in the exchange. The rationale behind providing the participating noteholders with such an instrument is to mitigate the noteholders' concerns about the excessive reduction of principal, by allowing them to ultimately recoup the money they waived pursuant to the restructuring.

iii. *Other Considerations*

Existing PDVSA Notes do not contain CACs. CACs eliminate the unanimous consent requirement to amend core provisions of notes, instead only a qualified majority (usually between 75% and 85%) must consent, thus mitigating the risk of holdouts. The efficiency of CACs can be further strengthened if the required thresholds contained in the CACs are calculated amongst all noteholders and not on a series-by-series basis. Series-by-series CACs present the risk that a holdout would acquire enough instruments of a certain series to prevent reaching the CAC threshold, thus jeopardizing the entire restructuring. We suggest that the New PDVSA Notes incorporate The International Capital Markets Association's (the "ICMA") "aggregate CACs" language,[21] which would allow enough flexibility to the noteholders for any potential amendment of the New PDVSA Notes and mitigate the risk of holdouts.

The Second Circuit in a series of decisions[22] considering the *pari passu* clause on behalf of NML has upset market participants and created uncertainty. The Second Circuit affirmed the District Court's injunction preventing Argentina from making payments on the newly restructured external debt without also making ratable payments to the holdout

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[21] *See* International Capital Markets Association, STANDARD AGGREGATED COLLECTIVE ACTION CLAUSES ("CACS") FOR THE TERMS AND CONDITIONS OF SOVEREIGN NOTES (August 2014).
[22] *See e.g. NML Capital, Ltd. v. Argentina*, 699 F.3d 246, 264 (2d Cir. 2012); *NML Capital, Ltd. v. Argentina*, 727 F.3d 230 (2d Cir. 2013), *cert. denied* 134 S.Ct. 2819 (June 16, 2014).

creditors.[23] Following these decisions, the market has signaled uncertainty as to whether the *pari passu* clause requires equitable and ratable payments to all creditors. ICMA provided an updated model *pari passu* clause[24] that rejects the court's reading. We suggest that the New PDVSA Notes incorporate ICMA's language in order to clarify the meaning of the *pari passu* provision. This would avoid any future misinterpretation by the courts and mitigate the risk of holdouts obtaining ratable payment on their debt instruments to the detriment of those who participated in the exchange. On the other hand, the Existing PDVSA Notes include in their *pari passu* clauses that the new debt will rank *pari passu* with other debt "other than obligations granted preferential treatment pursuant to the laws of Venezuela." This language means that Venezuela/PDVSA have the means to make the New PDVSA Notes rank higher than the Existing PDVSA Notes, without violating the *pari passu* clause. This is beneficial because it will encourage more of the existing noteholders to exchange because they know that they will be more likely to receive payment on the New PDVSA Notes if they rank higher than the Existing PDVSA Notes.

2. Protection Against Holdouts Through Exit Consents

Using exit consents, when holders of Existing PDVSA Notes accept the exchange they vote to amend certain provisions in the Existing PDVSA Notes to weaken the holdouts' ability to enforce the Existing PDVSA Notes and to ensure PDVSA's negotiation leverage against the holdouts.[25] If the holdouts maintain fierce tools to enforce the Existing PDVSA Notes after the restructuring it may interfere with the successful implementation of the restructuring plan (e.g., by foreclosing the core assets owned by PDVSA). It also may cause coordination failure among noteholders, because the potential benefits gained by holding-out

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[23] *See NML*, 699 F.3d at 264.
[24] *See* International Capital Markets Association, STANDARD *PARI PASSU* PROVISION FOR THE TERMS AND CONDITIONS OF SOVEREIGN NOTES (August 2014).
[25] *See* Lee C. Buchheit & G. Mitu Gulati, *Exit Consents In Sovereign Bond Exchanges*, 48 UCLA L. Rev. 59 (2000).

and free-riding would significantly demotivate the noteholders from accepting the exchange offer. The utilization of exit consents may increase the risk that courts find the exchange offer coercive (and an amendment made by the exit consent as invalid), but some coercion is necessary to achieve an orderly restructuring, which would benefit all the noteholders. Therefore, we recommend that PDVSA provides reasonable benefits for consenters in the exchange offer, and mitigates the potential holdouts by utilizing the exit consent as follows.

i. Pari Passu Provision

We recommend adding language to the *pari passu* clause in the Existing PDVSA Notes to the effect that the clause does not obligate PDVSA to make equal and ratable payments to Existing PDVSA Notes as PDVSA pays other indebtedness, including the New PDVSA Notes. This amendment would prevent holdouts from leveraging possible injunctions based on the *pari passu* clause (following the NML line of cases mentioned above) to then be used as leverage to force PDVSA to repay the Existing PDVSA Notes in full. This amendment might run the risk of violating the Existing PDVSA Notes' provision "no amendment may impair the right of each holder to receive payment."[26] However, in the absence of extraordinary behavior[27] as found in the NML cases, it is unclear if the *pari passu* clause would even be construed as it was in NML to force a country to pay all noteholders equally and ratably. If it is not interpreted as it was in NML, but as it has always been as mere boilerplate,[28] then the amendment of the *pari passu* clause in the Existing PDVSA Notes will

[26] This is because by changing the language, PDVSA has impaired the ability of the old noteholders to be paid equally and ratably with the new noteholders, following the NML line of cases interpretation of the *pari passu* clause.
[27] The court in *NML* interpreted *pari passu* as meaning that all external debt must be paid equally and ratably to justify an injunction for Argentina to pay the holdouts, because of the presence of three elements, not just because one creditor was paid over another. The second circuit explicitly warned "[w]e have not held that a sovereign debtor breaches its *pari passu* clause every time it pays one creditor and not another, or even every time it enacts a law disparately affecting a creditor's rights." The second circuit affirmed the "district court's conclusion that Argentina's extraordinary behavior was a violation of the particular *pari passu* clause." This extraordinary behavior was not only Argentina not paying the old bonds, but enacting legislation specifically forbidding even negotiation with the holders of old bonds.
[28] *Id.*

not be found to be an impairment of each holder's right to receive payment. This amendment is strongly recommended to lessen the consenters' concern of a possible injunction that might be imposed on payments to the New PDVSA Notes.

ii. Existing PDVSA Notes Trustee

In order to mitigate the potential impacts of a *pari passu* injunction, the Existing PDVSA Notes exchanged against the New PDVSA Notes should be transferred to a trust, so if required PDVSA can make "equal and ratable" payment on all Existing PDVSA Notes to the extent necessary to keep the New PDVSA Notes current while complying with the injunction, rather than making full repayment of principal and accrued interest to the holdouts' Existing PDVSA Notes while simultaneously only making full repayment of interest on the New PDVSA Notes. The trust will be mandated to (a) pay any proceeds from the Existing PDVSA Notes in trust to the noteholders who own the Exchanged PDVSA Notes so as to satisfy PDVSA's payment obligation under the Existing PDVSA Notes; (b) exercise the voting rights attached to the Existing PDVSA Notes in trust, consenting to any amendment, waiver and other proposals suggested regarding the Existing PDVSA Notes by PDVSA and dissenting on any of these suggested by holdouts;[29] (c) waive the Existing PDVSA Notes in trust upon the full repayment or discharge of the New PDVSA Notes and transfer the residual value (if any) to PDVSA;[30] and (d) if PDVSA breaches its sinking fund covenants and/or upon the request of the New PDVSA Noteholders, exchange the Existing PDVSA Notes with the New PDVSA Notes and waive the New PDVSA Notes so exchanged.[31]

[29] This is a backstop for holdouts' potential attempts to exploit any loopholes by obtaining and abusing the supermajority control in the Existing PDVSA Notes, which may occur if PDVSA cancels the Existing PDVSA Notes exchanged against New PDVSA Notes.
[30] This ensures that the trust exists only to the extent necessary to perform PDVSA's obligation under the New PDVSA Notes and no residual value remains in the trust after the New PDVSA Notes are paid in full.
[31] This enhances the pressure on PDVSA to comply with its covenants regarding the sinking funds.

iii. *Replacement of the Principal Paying Agent*

Replacing the principal paying agent, and the principal place of payment and interest of the Existing PDVSA Notes to Venezuela constitutes strong protection measures against potential holdouts in the exchange offer. Under this scenario, holdouts' ability to repatriate their funds from Venezuela would be impaired by the enactment of restrictive local laws and the establishment of capital control measures.[32] It should be noted that such an amendment is unlikely to violate Section 9.02(b)(vi), which requires the consent of all the noteholders if an amendment impairs the right of each noteholder to receive payment of principal or interest, provided that Venezuela does not immediately enact restrictive local laws or establishes capital control measures.

iv. *Sharing Clause*

To discourage Existing PDVSA Noteholders from holding out and gaining a disproportionate recovery from the Existing PVSDA Notes, we recommend adding a sharing clause (similar to the one used in syndicated loans) that requires all Existing PDVSA Noteholders to transfer all proceeds that they receive from the Existing PDVSA Notes (less their ratable share of the proceeds) to a trustee. The trustee can then distribute the proceeds ratably to all Existing PDVSA Noteholders (including the trust and the holders who have transferred the proceeds to the trustee).

v. *Release of the Collateral*

As previously discussed, the Extended PDVSA Notes are secured by collateral, which requires the consent of at least 66 2/3% in aggregate principal amount of the outstanding

[32] Section 8.03 of the Indenture provides a mechanism for the replacement of the Principal Paying Agent subject to the consent of the holders of more than 50% in aggregate principal amount of the Outstanding Notes (the "Required Holders"). However, paragraph (d) of Section 8.03 specifies certain requirements as to the identity of the Principal Paying Agent (*i.e.* the Principal Paying Agent shall be organized under the laws of the United States or of any State thereof or a Western European country) which limits the ability to shift the place of payment to Venezuela. Therefore, we suggest to use the exit consent mechanism in order to (1) amend Section 8.03 to include the possibility to designate an institution organized under the laws of Venezuela as the Principal Paying Agent and (2) replace the current Principal Paying Agent by such an institution in Venezuela.

Extended PDVSA Notes to be released. In dealing with the Extended PDVSA Notes, it is of utmost importance that any holdout creditor of these notes loses the benefit of this security from the ability to enforce the collateral if PDVSA defaults on the Extended PDVSA Notes, which would pose a serious risk for PDVSA's operations in the U.S.

In order to mitigate such risk, we suggest that the Extended PDVSA Noteholders participating in the restructuring vote for the release of the collateral prior to the exchange. Such vote would require a majority of at least 66 2/3% in aggregate principal amount of the outstanding Extended PDVSA Notes. In return for their vote, the participating noteholders would receive a first-priority lien over the collateral to secure their respective New PDVSA Notes.

vi. Mitigating the risk of the Guaranties

All Existing PDVSA Notes and Extended PDVSA Notes are guaranteed by PDVSA Petróleo S.A., a direct subsidiary of PDVSA. We suggest two alternative mechanisms in order to mitigate the risk of holdouts gaining disproportionate recovery by exercising their rights under the guaranties.

a. Amendment of the Indenture

The first mechanism consists in amending the Indenture to strip the guaranty from the holdouts. Since Article VII of the Indenture does not provide a specific mechanism for the release of the guaranty, the guaranty can be amended and released in accordance with Section 7.02(b) and Section 9.02(a), unless such an amendment constitutes an impairment of the right of each holder to receive payment in accordance with Section 9.02(b)(vi).

The Indenture incorporates the provisions of the Trust Indenture Act of 1939 (the "TIA") and in particular Section 316 (b) that provides that "the right of any holder of an indenture security to receive payment of the principal of and interest on such indenture security (...) shall not be impaired or affected without the consent of such holder."

In January 2017, the U.S. Court of Appeals for the Second Circuit issued an opinion overturning a broad interpretation of the TIA by the U.S. District Court for the Southern District of New York.[33] In *Marblegate*, the Second Circuit held that Section 316(b) of the TIA prohibits only non-consensual amendments to an indenture's core payment terms, such as the amount of principal, interest and term, and does not guarantee a holder that non-core payment terms, such as covenants and guaranties, cannot be modified or removed.

It should be noted, however, that in reaching its decision, the District Court heavily relied on the analysis of the legislative history surrounding the TIA, as it explained that "the history of the TIA, and of Section 316(b) in particular, shows that it does not prohibit foreclosures even when they affect a noteholder's ability to receive full payment. Rather, the relevant portions of the TIA's legislative history exclusively addressed formal amendments and indenture provisions like collective- action and no-action clauses." Moreover, whether or not PDVSA is subject to the TIA is itself questionable since, as discussed in the following section, the wholly-state owned company may be considered as an instrumentality of the government of Venezuela and thus its securities may be exempted pursuant to Section 304 of the TIA.

Nevertheless, the fact that the Indenture incorporates the language of the TIA suggests that the parties thereto intended to be subject to the legal principles governing the TIA. Therefore, in examining the legality of PDVSA's out of court restructuring, *Marblegate* would certainly provide guidance and, following the analysis of the Court, the release of the guaranty should not be considered as a violation of Section 316(b) as it is non-core payment term. Consequently, the approval by a simple majority obtained through an exit consent should suffice to release the guaranty.

[33] *Marblegate Asset Mgmt. v. Educ. Mgmt. Corp.*, 75 F. Supp. 3d 592 (S.D.N.Y. 2014); 111 F. Supp. 3d 542 (S.D.N.Y. 2015)

b. Asset Stripping

The second mechanism consists of stripping all assets from the guarantor and transferring those assets to a newly incorporated PDVSA subsidiary. The new entity would provide a guaranty with respect to the New PDVSA Notes, while the old entity would continue to guarantee the Existing PDVSA Notes, but it would be understood that the old entity would be unable to perform under the guaranty due to the lack of assets. Such transfer of assets, however, constitutes a major risk for the guarantor because this transaction is likely to be considered a fraudulent conveyance of assets. For this reason, we strongly caution against resorting to this solution prior to releasing the guaranties by amending the Indentures.

In this scenario, our focus is on the covenant contained in Section 4(d)(2) which provides that "any direct or indirect Subsidiary of [PDVSA] may (…) transfer, lease or otherwise dispose of assets (…) in cases when the transaction would not have a material adverse effect on [PDVSA] and its Subsidiaries taken as a whole." There is little doubt that the transfer of all the guarantor's assets to a newly incorporated entity would have a material effect and the violation of this covenant would constitute an Event of Default under the Existing PDVSA Notes in accordance with Section 5.01(3) of the Indenture. Nevertheless, Section 4.01(d)(5) provides that the holders of at least a majority in the principle amount of the Outstanding Notes can waive PDVSA's compliance obligation with its covenants. Similar to previous scenarios, such consent could be obtained through the exit consent mechanism.

While such transaction may raise the risk of piercing the guarantor's corporate veil to PDVSA, it would not create any downside because the obligation to be imputed to PDVSA by piercing the veil is to guarantee the performance of its own obligation.

C. Risk of Piercing the Corporate Veil

Venezuela may be tempted to strip PDVSA of its oil license and nationalize its assets, as opposed to just transferring the oil rights to another company and leaving PDVSA as a shell company. If it does so, it puts Venezuela at risk of having the corporate veil of PDVSA pierced and PDVSA's liability then becomes Venezuela's. A court is most likely to disregard the legally separate status between Venezuela and PDVSA if it can be shown that PDVSA is acting as an alter-ego[34] for Venezuela, by demonstrating that Venezuela is controlling PDVSA more than a majority shareholder would typically exercise control.[35] Here PDVSA and Venezuela arguably commingled assets[36] because: (1) PDVSA has been required to contribute significant sums of money to funds supporting Venezuela's social programs, such as FONDEN;[37] (2) Venezuela has entered into several crude oil supply agreements directly with foreign governments that require PDVSA to deliver hydrocarbons in accordance with terms negotiated by Venezuela;[38] (3) Note 15 of the financial statement of FY2015 shows a transaction where PDVSA's profits were being manipulated so the Venezuelan government could draw money from the central bank in a circumvention manner.[39] Additionally, the contributions to social projects arguably forced PDVSA to "disregard its commercial mission" and near the zone of insolvency.

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[34] *First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611 (1983) (establishing a presumption that instrumentalities and their sovereigns have separate legal entities, which can be overcome if (i) the instrumentality is so extensively controlled by the sovereign that a relationship of agent and principal exists; or (ii) the recognition of an instrumentality's separate legal entity would result in fraud or injustice).

[35] *Seijas v. Republic of Argentina*, 2012 U.S. App. LEXIS 22167 (2d Cir. 2012) (holding that a lawful control of the majority of the board's directors does not make the instrumentality an alter ego of the state); *Transamerica Leasing Inc. v. La Republica de Venezuela*, 200 F.3d 843, 849 (D.C. Cir. 2000) ("If majority stock ownership and appointment of the directors were sufficient, then the presumption of separateness announced in Bancec would be an illusion.").

[36] *See supra* note 34.

[37] *See supra* note 6.

[38] On August 23, 2010, a crude-oil supply agreement was executed between Venezuela and China, pursuant to which PDVSA supplies to China National Petroleum Corporation up to 300,000 barrels per day until the expiration of the contract. Similar supply agreements were entered between Venezuela and foreign governments, such as Russia.

[39] One additional scenario which may support a finding of commingling of funds is the fact that in Note 15 of the financial statement for FY2015 there was a transaction where the central bank of Venezuela purchased from PDVSA promissory notes issued by Nicaragua, El Salvador, Belize, Dominican Republic, San Cristobal and Nieves. This transaction generated $8.0bn financial income for PDVSA, though the book value of these notes was $4.3bn. It seems that the notes are junk and this transaction is quite unusual. It may imply that the PDVSA's profits were manipulated by this transaction and PDVSA is being used as Venezuela government's device to draw cash from the central bank in a circumvential manner. With all these circumstances in mind, the Venezuelan government is not totally remote from the risk that courts will find PDVSA as Venezuela's alter ego.

This already existing evidence combined with Venezuela deciding to strip PDVSA of its oil rights and nationalizing its assets may be enough to demonstrate that PDVSA is merely an alter ego for Venezuela leading a court to decide to pierce the corporate veil. If the doctrine applies, courts may impute the acts of PDVSA to Venezuela, and therefore, PDVSA's creditors may also benefit from the waiver of Venezuela's sovereign immunity and may try to seize Venezuela's assets abroad or interrupt its international trades (such as seizing oil tankers and intercepting financial deals) as if they are the holders of Venezuela's own notes. This risk makes it paramount that PDVSA restructures its debt in such a way to decrease holdouts, because less holdouts means less chance of this argument being pursued, and therefore, less risk of the corporate veil being pierced.

III. Restructuring of Venezuela's debt

We recommend soliciting a voluntary exchange of the existing notes (the "Existing Venezuela Notes") against new notes (the "New Venezuela Notes") bearing a reduced principal amount in conjunction with the use of CACs.

A. Considerations in structuring Venezuela's package deal

The restructuring of Venezuela notes will fundamentally follow the PDVSA scenario with the difference that Venezuela notes can be subdivided into three categories: (1) non-CACs notes, (2) 75% CACs notes and (3) 85% CACs notes. The presence of CACs in most of Venezuela's notes will facilitate the restructuring and mitigate the risk of holdouts provided that the required thresholds of consenting noteholders are reached. Therefore, the exchange of Venezuela's notes would be highly dependent on the incentives noteholders are presented with. Additionally, a series of Existing Venezuela Notes[40] is secured by collateral (obligations a face amount of which is not less than the aggregate principal amount of the notes).[41]

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[40] Collateralized Floating Rate Bonds due 2020 and Collateralized 6.75% Bonds due 2020.

[41] The release of the collateral requires the unanimous consent of the noteholders; we cannot prevent the holdouts from foreclosing the collateral in the event of the default of the notes. The collateralized assets are not

B. Use of CACs in Conjunction with an Exchange Offer

The availability of CACs in all but three issues of Venezuelan notes[42] provides for the possibility to amend the terms of the Existing Venezuela Notes. Most of the Existing Venezuela Notes that contain CACs require the vote of either 75% or 85% of the noteholders to amend core provisions, such as change of principal amount. Accordingly, as further explained below, Venezuela can simultaneously offer the combination of (a) an exchange of Existing Venezuela Notes with New Venezuela Notes, conditional upon the satisfaction of the relevant series' exit consent threshold; (b) an amendment to Existing Venezuela Notes to conform their terms with New Venezuela Notes through CACs; and (c) an amendment to Existing Venezuela Notes to address holdouts problem through exit consent. Even if the consent to item (b) does not reach the required majority to amend the Existing Venezuela Notes, or the relevant series does not include CACs, the exchange as referred to in item (a) and amendment by exit consent as referred to in item (c) would occur as long as Venezuela obtains majority consent in the relevant series.

1. Incentives for Participating Noteholders

i. Sinking Funds

To demonstrate Venezuela's commitment to repay its restructured debt and grant reasonable protection for creditors to secure such repayment, Venezuela may also introduce sinking funds as proposed for PDVSA. Since the idea of profit, free cash flow or distribution referred to in PDVSA's sinking fund mechanism are in the corporate context, the amount to be transferred to Venezuela's sinking funds should be calculated differently. For example, the amount may be proportionate to the amount of Venezuela's revenue relating to its oil reserve in any form (such as sales proceeds, tax or other levy on PDVSA's revenue from oil).

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used as operating assets; therefore the foreclosure will only have a financial impact, unlike PDVSA's pledge over (50.1% of Citgo shares).

[42] 9.25 % Unsecured Global Bonds due 2027, Collateralized Floating Rate Bonds due 2020 and Collateralized 6.75% Bonds due 2020, and 13 5/8% Global Bonds due 2018.

ii. Oil Warrants

To encourage noteholders to participate in the exchange, Venezuela should add oil-warrants to the New Venezuela Notes. Warrants allow the noteholders to receive back potentially some of the principle they took a haircut on or the potential to even profit. They also benefit Venezuela by granting them much needed time to not worry about a payment obligation and focus on economic recovery.

Oil warrants are preferable to GDP warrants because oil revenues constitute 95% of Venezuela's income and 50% of its GDP, so oil prices determine Venezuela's economic recovery, and thus Venezuela ability to service these warrants. The warrants will be structured in such a way to not be paid, until a certain oil price threshold has been met, determined by economic analysis that has calculated how much oil prices need to increase to help repair Venezuela's economy and to allow it to invest back in its oil production. Furthermore, GDP warrants are not preferred because GDP is based on data that Venezuela would provide which creates uncertainty and room for manipulation, which is particularly risky under Venezuela's new "dictatorship." Comparatively, oil prices are determined by the global market, therefore free from Venezuela's manipulation and a better measure of Venezuela's economy, compared to GDP.

There have been concerns about pricing with GDP-warrants but recently Singapore had a successful warrant program because they were managed successfully. Venezuela must follow in Singapore's footsteps to avoid the problems of the Brady bonds warrants.[43]

[43] *See* IMF, *How to Evaluate GDP-Linked Warrants: Price and Repayment Capacity*, Working Paper no. 85 (March 2006).

iii. *Other Considerations*

Similar to PDVSA's restructuring, we propose aligning the *pari passu* language in all New Venezuela Notes following the model suggested by ICMA.[44] In addition, to secure this proposed restructuring's success and just in case future restructuring of the New Venezuela Notes becomes necessary, we recommend amending the wording of the CACs to reflect that suggested by ICMA's "aggregate CACs language."[45]

2. Protection against holdouts by way of exit consents

For the Existing Venezuela Notes that do not include CACs, or in the event of failure to obtain the required majority to amend the Existing Venezuela Notes that do have CACs, exit consents can provide a solution to exchange those notes with New Venezuela Notes that include new terms.

We suggest implementing similar restrictive covenants in the Existing Venezuela Notes as for the PDVSA restructuring by way of exit consents: an amendment to *pari passu* clause[46], an amendment of the place of payment, the replacement of the Principal Paying Agent, the implementation of the Existing Venezuela Notes trustee, and the introduction of a sharing clause.

IV. Conclusion

This proposal we believe will encourage as many noteholders as possible to agree to the restructuring, which is beneficial for them because it will increase the likelihood that they

[44] *See supra* note 9.
[45] *See supra* note 10.
[46] Most of the Venezuela notes include in their *Pari Passu* clauses a language that the notes will rank equally with other debt, "save for such exceptions as may be provided by applicable legislation." This language means that Venezuela has the means to make the new notes rank higher than the old notes without violating the *pari passu* clause. This change in ranking will decrease the risk of holdouts' intervention utilizing *pari passu* injunction on the payment to new notes. However, three series of notes do not have the quoted language (namely, US $252,811,000, 13 5/8%, due 2018, US $4Bill, 9.25% due 2027, and US $1Bill, 9.375% due 2034). There may be an issue with these three notes series, that is, the interpretation of the *pari passu* clause triggers the injunction ordered in NML case. For these three notes, similar to PDVSA's restructuring, we propose aligning the *pari passu* language in the all Venezuela Notes following the model suggested by ICMA.[46] Amending the *pari passu* provision requires the vote of the majority of the noteholders only since it is not considered a reserved matter that requires the vote of a supermajority.

will have their debt obligations paid. It is also beneficial to both Venezuela and PDVSA because it will help to rebuild creditor confidence in their ability to repay their debt obligations and increase their access to capital markets and further investment. It should be noted though that under the current administrative and political turmoil it is unclear if Venezuela has any interest in pursuing a debt restructuring and attempting to rebuild economic stability. This is why it is paramount for any plan to be both beneficial to the creditors and Venezuela, and we believe our plan strikes that delicate balance.