More on the Validity of the PDVSA 2020 Bonds

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Governments with no realistic prospect of paying their debts often gamble for redemption, trying desperately to avoid default. Political leaders, with good reason, fear that a debt default will get them thrown out of office. But in trying to hold power, sometimes by borrowing even more, they often make matters worse for the country and its people. A prime example involves the collateralized bonds issued by Venezuelan state oil company, PDVSA.

Venezuela's Gamble

In 2016, PDVSA was about to default on its debt, as was the Venezuelan state itself. At that stage, it was already well beyond the point where the debt should have been restructured, given worsening domestic conditions. Instead, the Maduro government gambled. It conducted a debt swap in which investors exchanged unsecured PDVSA bonds for new ones due in 2020. To sweeten the deal, the PDVSA 2020s were backed by collateral in the form of a 50.1% interest in CITGO Holding, the parent company of U.S. oil refiner CITGO Petroleum. The deal bought a few extra years but put at risk the country's primary asset in the United States.

Even at the time, it was uncertain whether Venezuelan law authorized the transaction. The Venezuelan Constitution requires legislative approval for contracts in the national public interest. Maduro did not seek approval because opposition lawmakers controlled the National Assembly and had made clear they would not grant it. The deal went ahead anyway.

Times have changed. The United States recognizes Juan Guaidó as Venezuela's interim president (for now). The PDVSA 2020 bonds are in default. The bondholders want their collateral. PDVSA has challenged the validity of the bonds. But the bonds include a choice-of-law clause designating the law of New

York. Does this mean that validity is to be determined under New York law? John Coyle recently wrote a terrific post about the case and its significance on this blog. We write to provide some broader context, drawing from our article, Unlawfully Issued Sovereign Debt.

Sovereign Debt and Choice-of-Law Clauses

The story of the PDVSA 2020 bonds is a common one in government debt markets. A government borrows money in dodgy ways or at a time of financial distress. Arguably, the debt contravenes domestic law, although the government may obtain legal opinions affirming its validity. The debt also includes a choice of law clause providing for the application of foreign law, typically that of New York or England. Later, a new government comes to power and disputes the validity of the debt. We have seen this pattern in Venezuela, Mozambique, Ukraine, Zambia, Liberia, Puerto Rico, and in other sovereign and sub-sovereign borrowers. (The pattern goes back even further – for a delightful treatment of the hundreds of such cases from the 1800s involving municipal debt, see here).

These cases raise what seems like a simple question: Does an international bond—i.e., one expressly made subject to foreign law—protect investors against the risk that the bond will later be deemed in violation of the issuer's domestic law? Despite seeming simple, and how frequently the question arises, there is little clarity about the answer. New York law governs a big part of the sovereign debt markets, and the choice-of-law question in the PDVSA 2020 case has been certified to the New York Court of Appeals. Will that court's decision offer clarity?

Variations in Clause Language

Count us skeptical. The problem is not just the unpredictability of choice of law rules. It is that many choice-of-law clauses are drafted in perplexing ways, which leave unclear the extent of protection they offer to investors. Consider three examples. The first is from the PDVSA 2020 bond itself where the relevant language is capitalized (as if capitalization has some magic effect):

> *THIS INDENTURE AND THE NOTES SHALL BE CONSTRUED IN ACCORDANCE WITH, AND THIS INDENTURE AND THE NOTES AND ALL MATTERS ARISING OUT OF OR RELATING IN ANY WAY WHATSOEVER TO THIS INDENTURE AND THE NOTES (WHETHER IN CONTRACT, TORT OR*

> *OTHERWISE) SHALL BE GOVERNED BY, THE LAWS OF THE STATE OF NEW YORK WITHOUT REGARD TO THE CONFLICTS OF LAW PROVISIONS THEREOF (OTHER THAN SECTION 5-1401 OF THE NEW YORK GENERAL OBLIGATIONS LAW)*

This clause apparently seeks to extend New York law to the widest possible range of questions. Whether that includes the question of whether the bonds were validly issued is, as John's post puts it, the "billion-dollar question." And the answer is not clear. The decision by the New York Court of Appeals might provide some clarity on it . . . maybe.

But now consider this clause, from a Brazilian bond (emphasis ours):

> *The indenture and the debt securities will be governed by, and interpreted in accordance with, the laws of the State of New York without regard to those principles of conflicts of laws that would require the application of the laws of a jurisdiction other than the State of New York . . .;* ***provided, further, that the laws of Brazil will govern all matters governing authorization and execution of the indenture and the debt securities by Brazil.***

Does the bold text mean that investors cannot enforce a loan issued in violation of Brazilian law? We aren't sure. As we discuss in the paper, it can be hard to identify questions of "authorization" and "execution," especially in the context of sovereign borrowing. Consider the question whether a loan violates a constitutional or statutory debt limit. Does the debt limit negate the sovereign's capacity to borrow, limit the authority of government officials to bind the sovereign, or make the loan illegal or contrary to policy? How one categorizes the issue will affect the answer to the choice-of-law question. Carve outs like this—which reserve questions of authorization and execution for resolution under local law—appear in around half the New York-law sovereign bonds we examined.

Finally, consider this clause from a Turkish bond (again, emphasis ours):

> *[The] securities will be governed by and interpreted in accordance with the laws of the State of New York, except with respect to the authorization and execution of the debt securities on behalf of Turkey* ***and any other matters required to be governed by the laws of Turkey, which will be governed***

by the laws of Turkey

What now? This "other matters" carve out is even odder than the one for questions of authorization and execution. It hints that additional, unspecified matters might be governed by the sovereign's local law. Indeed, it implies that the sovereign's own law might determine which issues fall within the "other matters" exception. If so, the clause potentially allows the government to create new exceptions to the governing law clause.

Conclusion

Our discussions with senior sovereign debt lawyers have done little to dispel our uncertainty about the meaning of these clauses. They seem just as confused as we are. All we can say with confidence is that many choice of law clauses include traps for unwary investors. Until drafting practices converge on a consistent and coherent model, the choice-of-law question is likely to remain fodder for litigation.

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