The Billion-Dollar Choice-of-Law Question

Choice-of-law rules can be complex, confusing, and difficult to apply. Nevertheless, they are vitally important. The application of choice-of-law rules can turn a winning case into a losing case (and vice versa). A recent decision in the U.S. Court of Appeals for the Second Circuit, *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*, is a case in point. The Second Circuit was called upon to decide whether to apply the law of New York or the law of Venezuela to determine the validity of certain notes issued by a state-owned oil company in Venezuela. Billions of dollars were riding on the answer.

In this post, I first review the facts of the case. I then provide an overview of the relevant New York choice-of-law rules. Finally, I discuss the choice-of-law question that lies at the heart of the case.

The Bonds

In 2016, Venezuela's state-owned oil company, Petróleos de Venezuela, S.A. ("PDVSA") approved a bond exchange whereby holders of notes with principal due in 2017 (the "2017 Notes") could exchange them for notes with principal due in 2020 (the "2020 Notes"). Unlike the 2017 Notes, the 2020 Notes were secured by a pledge of a 50.1% equity interest in CITGO Holding, Inc. ("CITGO"). CITGO is owned by PDVSA through a series of subsidiaries and is considered by many to be the "crown jewel" of Venezuela's strategic assets abroad.

The PDVSA board formally approved the exchange of notes in 2016. The exchange was also approved by the company's sole shareholder and by the boards of the PDVSA's subsidiaries with oversight and control of CITGO.

The National Assembly of Venezuela refused to support the exchange. It passed two resolutions – one in May 2016 and one in September 2016 – challenging the power of the executive branch to proceed with the transaction and expressly rejecting the pledge of CITGO assets in the 2020 Notes. The National Assembly took the position that these notes were "contracts of public interest" which required legislative approval pursuant to Article 150 of the Venezuelan

Constitution. These legislative objections notwithstanding, PDVSA followed through with the exchange. Creditors holding roughly $2.8 billion in 2017 Notes decided to participate and exchanged their notes for 2020 Notes.

In 2019, the United States recognized Venezuela's Interim President Juan Guaidó as the lawful head of state. Guaidó appointed a new PDVSA board of directors, which was recognized as the legitimate board by the United States even though it does not control the company's operations inside Venezuela. The new board of directors filed a lawsuit in the Southern District of New York against the trustee and the collateral agent for the 2020 Notes. It sought a declaration that the entire bond transaction is void and unenforceable because it was never approved by the National Assembly. It also sought a declaration that the creditors were prohibited from executing on the CITGO collateral.

Choice of Law

If the 2020 Notes were validly issued, they are binding on PDVSA, and the CITGO assets may be seized by the noteholders in the event of default. If the notes were not validly issued, they are not binding on PDVSA, and the CITGO assets may not be seized by the noteholders in the event of default. Whether the Notes were validly issued depends, in turn, on whether the court applies New York law or Venezuelan law. This is the billion-dollar choice-of-law question. If New York law applies, then the notes will almost certainly be deemed valid and the noteholders can seize the pledged collateral. If Venezuelan law is applied, then the notes may well be deemed invalid and the noteholders will be stymied. With the stakes in mind, let us now turn to the applicable choice-of-law rules.

A federal court sitting in diversity must look to the choice-of-law rules of the state in which it sits—here, New York—to decide which jurisdiction's law to apply. N.Y. General Obligations Law 5-1401 states that a New York choice-of-law clause should be enforced whenever it appears in a business contract worth more than $250,000 in the aggregate. The 2020 Notes contain New York choice-of-law clauses. Since the aggregate value of the 2020 Notes is far greater than $250,000, and since the 2020 Notes have no relation to personal, family or household services, it may seem that the court should simply apply New York law and call it a day.

There is, however, another New York choice-of-law rule that may trump Section

5-1401. Section 5-1401 states that it shall not apply to any contract "to the extent provided to the contrary in . . . section 1-301 of the Uniform Commercial Code." Section 1-301(c) states that if N.Y Commercial Code Section 8-110 "specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law so specified." Section 8-110(a), in turn, states that "[t]he local law of the issuer's jurisdiction . . . governs . . . the validity of a security."

All of this suggests that the applicable choice-of-law rule may not be the one laid down in Section 5-1401. Section 8-110 directs courts to apply the local law of the issuer's jurisdiction—here, Venezuela—to resolve issues relating to the "validity" of the security. The billion-dollar question is what exactly the word "validity" means in this context.

On the one hand, the term may be interpreted broadly to refer to *both* the corporate law of Venezuela *and* to Venezuelan law more broadly. Under this interpretation, the 2020 Notes may not be validly issued because they were never approved by the National Assembly as required under Article 150. On the other hand, the term "validity" may be interpreted to refer only to the corporate law of Venezuela. Under this narrower interpretation, it is irrelevant whether the National Assembly approved the 2020 Bonds because all of the corporate formalities needed to validly issue a security—approval by the board of directors, approval by the shareholders, etc.—appear to have been followed.

Interpretation in the District Court

In a lengthy decision decided on October 16, 2020, the U.S. District Court for the Southern District of New York (Judge Katherine Polk Failla) concluded that the term "validity" should be given a narrow interpretation and that New York contract law governed the issue of validity.

The court began its analysis by observing that the strongest argument in support of a broad interpretation is based on plain language. This term "validity" is not generally understood to refer solely to corporate formalities. It is understood to encompass the many reasons why a contract may not be enforceable as a matter of contract law. While this plain language reading is compelling at first glance, the court ultimately concluded that it did not mandate the application of general rules of Venezuelan law given the broader context of Article 8.

The court first quoted the following language from the Prefatory Note to Article 8:

> *[Article 8] deals with the mechanisms by which interests in securities are transferred, and the rights and duties of those who are involved in the transfer process. It does not deal with the process of entering into contracts for the transfer of securities or regulate the rights and duties of those involved in the contracting process (emphasis added).*

The court observed that if the term "validity" were given a broad scope, it would "swallow whole any choice of law analysis involving the formation of a contract for securities." The court cited state legislative history indicating that the term "validity" in Article 8 referred merely to whether a security "ha[d] been issued pursuant to appropriate corporate or similar action." The court also quoted the authors of a leading treatise on Article 8 as saying that:

> *Obviously, the concept of "invalidity" as used in this section must have a narrower scope than one might encounter in other legal contexts, e.g., in a dispute about whether the obligation represented by the security is "enforceable" or "legal, valid, and binding."*

Finally, the district court noted the virtual absence of any New York case law supporting the broad interpretation of the validity favored by the plaintiffs. If the term was as sweeping as the plaintiff claimed, the court reasoned, there would be more cases where the courts had applied Section 8-110. The lack of any such cases cut against giving the term a broad interpretation. The district court's analysis of this issue has attracted support from some commentators and criticism from others.

After concluding that the term "validity" in Section 8-110 should be interpreted narrowly to select only Venezuelan corporate law, the district court applied New York contract law. It held that the 2020 Notes were valid and enforceable and that the defendant trustee was entitled to judgment in the amount of $1.68 billion. The plaintiffs appealed.

Interpretation in the Second Circuit

On October 13, 2022, the U.S. Court of Appeals for the Second Circuit declined to

provide a definitive answer as to the interpretive question discussed above. After reviewing the various arguments for and against a broad interpretation of "validity," the court certified the question to the New York Court of Appeals. In so doing, the court commented on the issue's importance to "the State's choice-of-law regime and status as a commercial center." It also noted the importance of the choice-of-law issue to the ultimate outcome in the case:

> *If the court concludes New York choice-of-law principles require the application of New York law on the issue of the validity of the 2020 Notes, and that Article 150 and the resolutions have no effect on the validity of the contract under New York law, then we would affirm the district court's decision to apply New York law and uphold the validity of the bonds. On the other hand, if the court concludes Venezuelan law applies to the particular issue of PDVSA's legal authority to execute the Exchange Offer, then we would likely remand for an assessment of Venezuelan law on that question and, if necessary, for consideration of the Creditors' equitable and warranty claims.*

The fate of the 2020 Notes—and the billions of dollars those notes represent—is now in the hands of the New York Court of Appeals.

Conclusion

There will be additional updates and commentary on *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.* at Transnational Litigation Blog in the weeks and months ahead. In the meantime, please feel free to mention this case the next time a student or a colleague questions the importance of choice-of-law rules. These rules matter. A lot.

[This post is cross-posted at Transnational Litigation Blog.]