An Answer to the Billion-Dollar Choice-of-Law Question

On February 20, 2024, the New York Court of Appeals handed down its opinion in *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.* The issue presented—which I described in a previous post as the billion-dollar choice-of-law question—was whether a court sitting in New York should apply the law of New York or the law of Venezuela to determine the validity of certain bonds issued by a state-owned oil company in Venezuela. The bondholders, represented by MUFG Union Bank, argued for New York law. The oil company, Petróleos de Venezuela, S.A. ("PDVSA"), argued for Venezuelan law.

In a victory for PDVSA, the New York Court of Appeals unanimously held that the validity of the bonds was governed by the law of Venezuela. It then sent the case back to the federal courts to determine whether the bonds are, in fact, invalid under Venezuelan law.

Facts

In 2016, 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—the Venezuelan government—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” that 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 (SDNY) against the trustee and the collateral agent for the 2020 Notes. It sought a declaration that the entire bond transaction was void and unenforceable because it was never approved by the National Assembly. It also sought a declaration that the creditors were prohibited from executing against the CITGO collateral.

The choice-of-law issue at the heart of the case related to the validity of the 2020 Notes. Whether the Notes were validly issued depended on whether the court applied New York law or Venezuelan law. The SDNY (Judge Katherine Polk Failla) ruled in favor of the bondholders after concluding that the issue was governed by the laws of New York. On appeal, the Second Circuit certified the choice-of-law question to the New York Court of Appeals. The Court of Appeals reformulated this question to read as follows:

> *Given the presence of New York choice-of-law clauses in the Governing Documents, does UCC 8-110(a)(1), which provides that the validity of securities is determined by the local law of the issuer’s jurisdiction, require the application of Venezuela’s law to determine whether the 2020 Notes are invalid due to a defect in the process by which the securities were issued?*

In a decision rendered on February 20, 2024, the Court of Appeals unanimously concluded that the answer was yes.

Section 8-110

The court began with the New York choice-of-law clauses in the Indenture, the Note, and the Pledge Agreement. Under ordinary circumstances, it observed, New York courts will enforce New York choice-of-law clauses by operation of Section 5-1401 of the New York General Obligations Law. That statute provides that the parties to any commercial contract arising out of a transaction worth more than $250,000 may select New York law to govern their agreement even if the transaction has no connection to New York. In this particular case, however, a different part of Section 5-1401 dictated a different result.

Section 5-1401 also states that even when parties choose New York law, that law "shall not apply . . . to the extent provided to the contrary in subsection (c) of section 1-301 of the uniform commercial code." UCC 1-301(c)(6) states, in turn, that if UCC 8-110 "specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted." Finally, UCC 8-110(a)(1) states that "[t]he local law of the issuer's jurisdiction . . . governs . . . the validity of a security."

After following the chain of choice-of-law rules from Section 5-1401 to UCC 1-301(c) to UCC 8-110, the court observed that the validity of a security is governed by the law of the issuer's jurisdiction. The court further observed, based on the statutory text, that Section 8-110 was a mandatory rule that could not be altered by a choice-of-law clause. Against this backdrop, the court held that "because UCC 8-110 is applicable here, any issue of the validity of a security issued pursuant to the Governing Documents is determined by the law of the issuer's jurisdiction. In this case, the issuer is a Venezuelan entity, so the law of Venezuela is determinative of the issue of validity."

Validity

The court next addressed the meaning of "validity" as used in Section 8-110. The bondholders argued that this term did not sweep broadly enough to encompass the requirement in Article 150 of the Venezuelan Constitution, which provides that the National Assembly must approve all "contracts of public interest." They argued that the word encompassed only the usual corporate formalities for issuing a security. PDVSA argued that "validity" could be interpreted to include constitutional provisions that bear on the issue of whether a security was duly authorized. The Court of Appeals agreed.

In reaching this conclusion, the court first observed that the issue of "validity" had to be distinguished from the issue of "enforceability." The first term refers to the "nature of the obligor and its internal processes." The second term refers to "requirements of general applicability as going to the nature of the rights and obligations purportedly created, irrespective of the nature of the obligor and its processes." The court cited usury laws and anti-fraud laws as examples of laws that dealt with enforceability rather than validity. Although these laws may prohibit a court from *enforcing* a contract, they do not bear on the *validity* of that same contract because they do not address the procedures that must be followed for the contract to be duly authorized.

The court then distinguished between (1) validity and (2) the consequences of invalidity. While Section 8-110 stated the controlling choice-of-law rule with respect to the validity, it was not controlling with respect to the consequences stemming from that invalidity. "Even if a court determines that a security is invalid under the local law of the issuer's jurisdiction," the court held, "the effects of that determination will depend on New York law."

With these distinctions in mind, the court held that "Article 150 and its related constitutional provisions could potentially implicate validity because they speak to whether an entity has the power or authority to issue a security, and relatedly, what *procedures* are required to exercise such authority." In particular, the court observed that this constitutional provision required the approval of the National Assembly before certain contracts could be executed. Since Article 150 identified procedural requirements rather than substantive ones, the court reasoned, it spoke to the issue of validity rather than enforceability. In so holding, the court reasoned that the term "validity," as used in Section 8-110, could implicate constitutional provisions of the issuer's jurisdiction that speak to whether a security is duly authorized.

Caveats

After holding that the issue of validity was governed by the law of the issuer's jurisdiction, and that Section 150 of the Venezuelan Constitution might be relevant to the issue of validity, the court went on to announce several important caveats.

First, the court stated that the application of Venezuelan law on these facts must be “narrowly confined.” It held that the “exception provided by UCC 8-110 provides no opportunity for the application of foreign laws going to the enforceability of a security, nor does it affect the adjudication of any question under the contract other than whether a security issued by a foreign entity is valid when issued.”

Second, the court emphasized that “none of this is to say that plaintiffs will ultimately be victorious.” It noted that the federal courts would still have to determine whether the securities were, in fact, invalid under the laws of Venezuela.

Third, the court went out of its way to emphasize the fact that—issues of validity notwithstanding—New York law governs the transaction in all other respects, including the consequences if a security was issued with a defect going to its validity.

Conclusion

This long list of caveats suggests that the Court of Appeals *wanted* to apply to New York law in this case to the maximum extent possible. Enforcing New York choice-of-law clauses, after all, generates business for New York lawyers, and the generation of such business ultimately benefits the State of New York. The Court was, however, unable to find an interpretive path that permitted it to apply New York law in light of the text of Section 8-110.

In the days following the court’s decision, several news outlets reported that the value of the PDVSA bonds at issue had fallen precipitously. This decline in price presumably reflects the market’s perception that the bondholders are less likely to gain access to the CITGO assets anytime soon (if at all) if Venezuelan law governs the validity issue. TLB will report on developments in this case going forward.

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