ALERT MEMORANDUM

New York Court of Appeals Holds that Venezuelan Law Governs the Validity of PDVSA's 2020 Bonds

February 27, 2024

On February 20, 2024, the New York Court of Appeals – analyzing questions certified to it by the United States Court of Appeals for the Second Circuit – issued its opinion in *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*,[1] a case in which Petroléos de Venezuela ("PDVSA") seeks invalidation of its bonds maturing in 2020 (the "2020 Bonds"). The N.Y. Court of Appeals held unanimously that N.Y. UCC § 8-110(a)(1), which provides that the local law of the issuer's jurisdiction governs the "validity of a security", requires application of Venezuelan law to the question of whether PDVSA's 2020 Bonds were validly issued, or void *ab initio*. The case now goes back to the federal courts for determination of whether the PDVSA 2020 Bonds are invalid because, according to PDVSA, they constitute a "contract of national public interest" which Article 150 of the Venezuelan Constitution required the Venezuelan National Assembly to approve.

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[1] *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*, 2024 N.Y. Slip Op. 00851 (N.Y. Feb. 20, 2024) ("N.Y. CoA Op.").

PDVSA's Exchange Offer and Default

The story of the 2020 Bonds originates with bonds issued by PDVSA in 2007, 2010, and 2011, all of which were set to mature in 2017 (the "2017 Bonds"). As the 2017 Bonds' maturity approached, it became clear that, due to declining oil revenues and other economic and political factors, PDVSA was likely to default on its payment obligations.[2]

In September 2016, PDVSA, with the hope of staving off default, announced an exchange offer for the 2017 Bonds, whereby holders who elected to participate would receive the longer-dated 2020 Bonds. In order to incentivize holders to accept the exchange offer, the 2020 Bonds would be secured by 50.1% of the shares of Citgo Holding. The pledge was made through PDVSA's wholly-owned subsidiary PDV Holding ("PDVH"), a Delaware corporation that in turn controls Citgo Holding. MUFG Union Bank, N.A. ("MUFG") and GLAS Americas, LLC ("GLAS") served as trustee and collateral agent, respectively.[3]

The Indenture, Pledge Agreement, and Notes governing the transaction all contain choice-of-law provisions that unambiguously select New York law:

> "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)."[4]

Shortly after the exchange offer was announced, the Venezuelan National Assembly issued a resolution "reject[ing] categorically" the pledge of 50.1% of the equity of Citgo Holding.[5] This resolution was presumably in response to a March 2016 declaration by Venezuelan President Nicolás Maduro granting him the authority to execute "contracts of national public interest" unilaterally, notwithstanding Article 150 of the Venezuelan Constitution, which, while it does not define the term, provides that in certain cases the approval of the National Assembly is required for any such contracts to be executed. Shortly after Maduro's declaration in March 2016, the National Assembly had also passed a resolution reaffirming the requirements of Article 150 and declaring that any contracts executed in contravention of those requirements "shall be null and void in their entirety."[6] However, neither of the National Assembly's 2016 resolutions made explicit reference to the 2020 Bonds being a contract of national public interest.

The exchange offer expired in October 2017, with holders of just under 40% of the 2017 Bonds accepting the offer. The 2020 Bonds were issued on October 28, 2016, and included customary representations and legal opinions regarding validity.

Venezuela and PDVSA began to default on most of their unsecured bonds in late 2017, but PDVSA continued to make payments on the 2020 Bonds. Meanwhile, in 2018, Maduro was re-elected President of Venezuela in an election that the Venezuelan opposition and many international observers (including the United States) viewed as illegitimate. In January 2019, the National Assembly declared Maduro's presidency to be illegitimate and named Juan Guaidó, National Assembly President, as Interim President of Venezuela. Guaidó's government was quickly recognized as the legitimate government of Venezuela by the United States, and, in February 2019, Guaidó appointed a competing ad hoc board for PDVSA.

In October 2019, the National Assembly issued a third resolution regarding the issuance, concluding that "the 2020 Bond indenture is a national public contract that should have been authorized by the National Assembly, in accordance with Article 150 of the Constitution."[7] Later that month, PDVSA defaulted on the 2020 Bonds

[2] *Id.* at 4.
[3] *Id.* at 4–5.
[4] *Id.* at 5 (quoting the Indenture for the 2020 Bonds).
[5] *Id.* at 7.
[6] *Id.*
[7] *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*, 495 F. Supp. 3d 257, 267 (S.D.N.Y. 2020) (quoting October 15, 2019 National Assembly Resolution).

by failing to make a scheduled interest and amortization payment.

Procedural Background

On October 29, 2019, the Guaidó-appointed ad hoc board for PDVSA filed a complaint against MUFG and GLAS in the U.S. District Court for the Southern District of New York ("S.D.N.Y."). PDVSA's complaint sought a declaration that the agreements governing the 2020 Bonds were invalid and void *ab initio* due to the requirements of Article 150, as well as injunctive relief to prevent MUFG and GLAS from enforcing the terms of those agreements.[8] MUFG and GLAS counterclaimed, seeking a declaration that the 2020 Bonds were valid and enforceable, as well as damages for breach of contract, breach of warranty, unjust enrichment, and quantum meruit.[9]

On summary judgment, the trial judge (Failla, J.) ruled in favor of MUFG and GLAS, finding the 2020 Bonds valid and enforceable and issuing a judgment in favor of MUFG/GLAS for missed principal and interest payments under the 2020 Bonds. Judge Failla rejected PDVSA's argument that N.Y. U.C.C. § 8-110(a)(1)[10] required her to look to Venezuela law, in particular Article 150 of the Venezuela Constitution, to determine whether the 2020 PDVSA Bonds were validly issued. Instead, the court concluded that UCC § 8-110(a)(1) "has a far narrower understanding of 'validity' than [PDVSA's] varied assertions of invalidity due to illegality, or incapacity, or lack of authority."[11] Quoting from a leading UCC treatise, the court reasoned:

> "Article 150 'does not deal with the procedural or other requirements for issuance of securities by municipalities or corporations' organized under Venezuelan law. Instead, Article 150 requires National Assembly approval for a broad category of contracts, and has nothing specifically to do with the issuance of securities. It is far more similar to a 'provision of general applicability' that 'renders unenforceable a certain category of promises to pay money.'"[12]

As a result, the court determined that she did not have to consider PDVSA's Article 150 arguments on the merits. Determining that the 2020 Bonds were therefore valid and enforceable under New York law, the court entered judgment in favor of MUFG and GLAS in the amount of $1.9 billion.

PDVSA appealed the judgment to the Second Circuit Court of Appeals. Assessing the choice-of-law conclusions reached by the district court, the Second Circuit determined that there was not enough guidance from New York state courts on relevant choice-of-law questions, including most notably how to assess the term "validity" in UCC § 8-110(a)(1), and whether "validity" should be understood to encompass PDVSA's arguments about Article 150. The Second Circuit therefore certified the choice of law questions to the N.Y. Court of Appeals (the highest court of the state of New York), setting the stage for last week's ruling.[13]

The N.Y. Court of Appeals' Decision

In a unanimous ruling, the N.Y. Court of Appeals held that "validity" within the meaning of UCC § 8-110(a)(1) "requires courts to consider if the 2020 Notes were issued with defects going to their validity under Article 150 and other related provisions of Venezuela's Constitution."[14]

The court held that "validity" includes the procedure by which a security was issued and whether it was proper. Thus, Article 150 "could potentially implicate validity,"

[8] *Id.*
[9] *Id.*
[10] N.Y. UCC § 8-110(a)(1) provides that "The local law of the issuer's jurisdiction, as specified in subsection (d), governs . . . the validity of a security[.]" Subsection (d) in turn provides that "'Issuer's jurisdiction' means the jurisdiction under which the issuer of the security is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer." PDVSA asserts that Venezuelan law would not allow an issuer to specify that the law of another jurisdiction controls.
[11] *Petróleos de Venezuela S.A.*, 495 F. Supp. 3d at 286–87.
[12] *Id.* at 286 (quoting 7 William D. Hawkland, *et al.*, UNIFORM COMMERCIAL CODE SERIES § 8-110:2 (2020)) (internal citations omitted).
[13] *See Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*, 51 F.4th 456, 474–76 (2d Cir. 2022) (certifying choice-of-law questions to the N.Y. Court of Appeals).
[14] N.Y. CoA Op. at 22.

because it speaks to "whether an entity has the power or authority to issue a security, and, relatedly, what *procedures* are required to exercise such authority."[15] Rejecting MUFG and GLAS's argument that Article 150 is a "law of general applicability" that need not be incorporated into the concept of validity, the court noted that "Article 150 specifically references the actual authority and process required for due authorization of national public interest contracts, which may include an issuance of securities under Venezuelan Law."[16]

On that basis, the court concluded that "despite the limited scope of the term 'validity' in UCC 8-110, determining whether the securities issued by these Venezuelan entities are valid requires analysis of Article 150 and related provisions of the Venezuelan Constitution, because those provisions *may* govern the process by which a security is 'duly authorized.'"[17]

The court's decision takes special care to limit the application of Venezuelan law only to issues of validity, holding that "Venezuelan law applies here only as to the validity of the securities issued by a Venezuelan entity, not as to other actions arising from or related to the transaction."[18] The court further held that, while "validity" must be determined under Venezuelan law, "all other issues . . . remain governed by New York Law."[19] Thus, "[e]ven if a security issued by a Venezuelan entity is invalid under Venezuelan law, the effect of that invalidity is nonetheless governed by New York law."[20] Finally, the court stressed that its decision must be "narrowly confined" in light of New York's status as a commercial center.[21] Thus, the concept of validity under UCC § 8-110(a)(1) "does not encompass all defects," only "constitutional provisions of the issuer's jurisdiction that speak to whether a security is duly authorized."[22]

Next Steps for the 2020 Bonds

The N.Y. Court of Appeals' decision is not a decisive victory for PDVSA. The case now returns to the Second Circuit, which will likely remand to Judge Failla to analyze whether Article 150 of the Venezuelan Constitution renders the 2020 Bonds invalid. Even if Judge Failla agrees with PDVSA's interpretation of Article 150 (*i.e.*, that the issuance of the 2020 Bonds required the prior approval of the National Assembly), MUFG and GLAS still have alternate theories of liability they can pursue. For example, MUFG and GLAS may pursue a claim for breach of warranty against PDVH for falsely representing and warranting in the pledge agreement that the transaction was duly authorized, required no additional action by any governmental authority, and did not contravene any applicable law.

Before remanding to the district court, the Second Circuit may seek the views of the parties as to next steps, including whether it should first consider other issues not addressed in its prior opinion, for example the act of state doctrine, an alternate argument raised by PDVSA for why the resolutions of the National Assembly declaring the 2020 Bonds invalid cannot be questioned by a U.S. court because (PDVSA argues) the resolutions effected a taking solely within Venezuela.

The timing of further litigation will depend on how quickly the parties and the Second Circuit and then the district court are willing to move, but there are a few factors to consider. It is possible that one or both of PDSVA or MUFG/GLAS may wish to reopen the record and develop additional expert evidence on the meaning of Article 150, which could be weeks or months of additional discovery.

Meanwhile, however, enforcement actions initiated by judgment creditors of Venezuela and PDVSA in the U.S. District Court in the District of Delaware continue, and creditors in those actions appear likely to succeed in forcing a sale of PDVH in the coming months.[23] In light of the impact this sale may have on the 2020 Bonds' claims, MUFG and GLAS may request

[15] *Id.* at 18–19 (emphasis in original).
[16] *Id.* at 19.
[17] *Id.* at 15.
[18] *Id*. at 14.
[19] *Id.*
[20] *Id.* at 14–15 (internal citations omitted).
[21] *Id.* at 22.
[22] *Id.* at 20.
[23] *See Crystallex Int'l Corp. v. Bolivarian Republic of Venez*., No. 17-mc-151 (D. Del.).

expedited consideration of the parties' summary judgment motions. Given that Judge Failla received extensive evidence, briefing, and oral argument on the relevant issues previously, she may be poised to rule fairly quickly on the renewed summary judgment motions.

In any event, however, any new judgment entered by Judge Failla will presumably result in another round of appeals to the Second Circuit. Thus, while MUFG/GLAS and holders of the 2020 Bonds still have paths available for victory, the clearest consequence of last week's decision is further delay for bondholders.

Implications for Other Foreign-Issued Securities

Going forward, the N.Y. Court of Appeals' decision expands the scope of what foreign laws might come into play when assessing the validity of foreign-issued securities with New York choice-of-law provisions. Because the court held that courts must consider "constitutional provisions of the issuer's jurisdiction that speak to whether a security is duly authorized"[24] in determining validity, this holding may create uncertainty as to whether other foreign-issued securities are valid. The N.Y. Court of Appeals appeared concerned about the impact of the holding on New York's "status as a commercial center" and so "narrowly confined" the holding to the issue of validity.[25]

In light of the decision, issuers of future foreign security issuances governed by New York law will likely need to provide a more robust legal opinion regarding, at a minimum, relevant constitutional provisions that may impact the validity of the security. As Judge Garcia observed during oral argument before the N.Y. Court of Appeals, this could raise the cost of future issuances of this nature because law firms may be challenged to issue a definitive legal opinion regarding validity.[26]

Furthermore, while the court's decision was focused on constitutional provisions that may impact whether a security was duly authorized, the court's logic conceivably extends to other sources of foreign law that could have a bearing on due authorization. For example, foreign statutory codes or regulatory requirements may also impose procedural requirements that bear on the question of due authorization, and it is not clear that last week's decision is limited to requirements stemming from foreign constitutions alone. Investors in and underwriters of foreign securities offerings would be well advised to take a closer look at these issues in light of this decision.

Finally, in addition to making the process of obtaining legal opinions for future foreign-issued New York law-governed securities more complicated, last week's decision may also open the door to additional challenges to the validity of previously-issued foreign securities. Here, however, investors can take comfort from the fact that the N.Y. Court of Appeals' decision emphasizes the continued applicability of New York law to the "consequences" of the issuance of an invalid security offering. Even where a security is determined to be invalid, for example, a good-faith purchaser for value without notice of the defect may, depending on the circumstances, rely on the provisions of UCC § 8-202(b) to protect his or her investment. While the impact of UCC § 8-202(b) remains to be determined for the 2020 Bonds, it is not clear when a holder of the 2020 Bonds would be on notice of the defect, given the past resolutions by the National Assembly as well as the commencement of the lawsuit seeing the 2020 Bonds' invalidation in October 2019.

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[24] N.Y. CoA Op. at 20.
[25] *Id*. at 22.
[26] Transcript of Oral Argument at 46-47, *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*, 2024 N.Y. Slip Op. 00851 (N.Y. Feb. 20, 2024).