Venezuela's Imminent Restructuring and the Role Alter Ego Claims May Play in this Chavismo Saga[1]

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The clock ticking down for investors holding the outstanding debt of the Republic of Venezuela and its state-owned oil company, Petróleos de Venezuela, S.A. ("PDVSA"), may have just struck zero. On Friday, November 3, President Nicolás Maduro kicked off the much anticipated restructuring of Venezuelan debt by announcing that after it makes a $1.1 billion principal payment on PDVSA bonds due on November 2, that it would commence restructuring negotiations with its creditors. Although the Government invited creditors to Caracas on November 13 to jump start negotiations, given the failed policies of the Maduro regime, the limitations posed by U.S. government sanctions and the risks creditors would face in accepting new instruments that could be challenged by a future Venezuelan government, the prospects of any type of restructuring being accomplished

anytime soon are quite remote. Should Venezuela fail to cure its existing payment defaults or not make payments during the pendency of any restructuring discussions, which seems to be the government's intent, one can expect Venezuela's legion of creditors to turn their immediate attention to scouring the globe for assets held in the name of the Republic and those entities, such as PDVSA, alleged to be the "alter egos" of the Republic.

This article discusses the legal framework for pursuing alter ego claims, including the continued efforts by Republic creditor Crystallex International Corporation ("Crystallex"), a Canadian gold-mining corporation, to collect on its $1.4 billion U.S. court judgment against the Republic from the assets of PDVSA, and evaluates the ability of other Republic creditors to pursue a similar strategy.

One thing is clear: Crystallex's efforts to pursue its alter ego claims against PDVSA will be closely watched by Republic and PDVSA creditors alike.

Introduction

Venezuela's Creditors are Diverse and Unaligned

Venezuela faces historic economic difficulties. As more fully discussed in a recent publication outlining a realistic renegotiation of Republic and PDVSA debt posted on the Harvard Law School Bankruptcy Roundtable and written by Rich Cooper and Mark A. Walker,[2] as of mid-September 2017, Venezuela and PDVSA faced at least $196 billion in liabilities, consisting of more than $120 billion in financial debt and forward oil sales, and another $75 billion of claims that include unpaid supplier and investment claims.

Any Venezuela restructuring faces a difficult path forward. Its creditors—including international bondholders, local suppliers and foreign state actors like the China Development Bank and Russian state-owned oil company Rosneft—are a diverse group, located worldwide and driven by different investment strategies and long-term goals. The country's most valuable assets—CITGO Petroleum Corporation ("CITGO") and receipts from the export of petroleum—are located outside Venezuela and therefore vulnerable to disruption and seizure by creditors under the laws of foreign jurisdictions such as the United States. Some unpaid Republic creditors—like Crystallex—have already asked courts to determine that PDVSA's assets should be available to satisfy its judgment against the Republic. Other creditors holding billions in arbitral awards are likely to follow. Crystallex may be furthest ahead, but the lessons learned in its multi-prong litigation are sure to quicken the path for those that follow.

U.S. Law Makes Enforcing Judgments Against Venezuela in the U.S. Difficult

U.S. law provides sovereigns like Venezuela certain protections not available to private debtors. The Foreign Sovereign Immunities Act of 1976 (the "FSIA") confers on the property in the United States of a foreign state (Venezuela) and its instrumentalities immunity from attachment and execution subject to certain exceptions discussed below.[3] Because PDVSA is directly majority-owned by Venezuela, PDVSA is an "instrumentality" also protected by the FSIA.[4] PDVSA subsidiaries (and parents of CITGO) like PDV Holding, Inc. ("PDV Holding") and CITGO Holding, Inc. ("CITGO Holding") are not protected by the FSIA because they are incorporated in Delaware. Other PDVSA subsidiaries incorporated in Venezuela may also not be protected under the FSIA due to their tiered ownership structure unless they themselves qualify as an "organ" of the Republic of Venezuela.[5]

Other than immune diplomatic property, Venezuela has no known unencumbered commercial assets in its own name in the United States.[6] This has forced Crystallex to seek to enforce its arbitral award in other countries such as the Netherlands and Canada and to focus on expanding the universe of assets available to satisfy its award against the Republic by alleging that non-Republic entities (like PDVSA) and their property in the United States are "alter egos" of the Republic. If Crystallex prevails, PDVSA's assets—to the extent not encumbered by nonvoidable prior security interests—will be available to satisfy Crystallex's judgment. Other Republic creditors holding judgments may be able to mirror aspects of Crystallex's enforcement strategy and should be monitoring these developments closely.[7]

Crystallex's Claims Against the Republic and Its Two-Front Collection Effort

Crystallex's dispute arises from the alleged nationalization of Venezuelan gold production under late President Hugo Chávez. A gold producer, Crystallex claimed that in February 2011 the Republic unlawfully terminated Crystallex's mining rights in the Las Cristinas gold reserve. In April 2011, Venezuela took

possession of Las Cristinas and expropriated hundreds of millions of dollars of Crystallex investments without compensation. Months later, Chávez nationalized gold production. Crystallex alleged that PDVSA, through an affiliate, later received Crystallex's former interests in Las Cristinas without paying any compensation to the government or Crystallex.

Crystallex initiated an arbitration in 2011 against the Republic. In April 2016, the International Centre for Settlement of Investment Disputes issued an award in Crystallex's favor in the amount of approximately $1.1 billion (including pre-award interest).[8] PDVSA was not a party to the arbitration or to the resulting award.

Because an arbitral award is not self-executing and Venezuela has refused to pay, Crystallex brought an action in April 2016 to recognize the award in the District Court for the District of Columbia and obtain a judgment of that court.[9] That confirmation, obtained in March 2017,[10] resulted in a judgment for $1.4 billion (including post-award, pre-judgment interest) capable of being judicially enforced in the United States. Although the Republic appealed confirmation of the award, it did not obtain a stay of the enforcement of the resulting judgment. In June 2017, the District Court for the District of Columbia issued an order—required under the FSIA—finding that sufficient time to permit voluntary satisfaction of the judgment had passed and authorizing Crystallex to commence judgment enforcement efforts, but not addressing the immunity status or amenability of any particular property to execution by Crystallex.[11]

PDVSA's principal asset in the United States is CITGO, which PDVSA owns through wholly owned corporate subsidiaries PDV Holding and CITGO Holding (both Delaware corporations). To be in a position to realize on the value of CITGO, Crystallex has initiated three different legal proceedings in Delaware to protect against the diminution in, and ultimately recover, Citgo's value. Crystallex must successfully prosecute all three causes of action in order to maximize its claims. To do so, it must overcome multiple hurdles.

Crystallex Fraudulent Transfer Litigation

To protect CITGO's value, Crystallex is attempting to unwind two allegedly fraudulent transactions that encumbered CITGO's value and diminished the possibility of Crystallex recovering in full.

First, presumably aware of the possibility of multiple forthcoming, billion-dollar arbitral awards being issued against the Republic, and anticipating (correctly) that such award holders might seek to enforce those awards against CITGO, in late 2014 and early 2015, CITGO Holding issued approximately $2.8 billion in non-investment grade debt and paid a dividend of approximately $2.8 billion to PDV Holding. PDV Holding subsequently paid PDVSA (in Venezuela) a $2.2 billion dividend.[12] Crystallex initiated a lawsuit in November 2015, *Crystallex Int'l Corp. v. Petróleos de Venezuela, S.A.* ("Crystallex I"),[13] under the Delaware Uniform Fraudulent Transfer Act,[14] against PDVSA, PDV Holding and CITGO Holding, seeking, among other relief, the return to the United States of the $2.2 billion that was sent to PDVSA and then allegedly to the Republic. *Crystallex I* is currently on appeal before the United States Court of Appeals for the Third Circuit, which will be deciding in the next few months whether Crystallex properly stated a claim under the Delaware Uniform Fraudulent Transfer Act against PDV Holding and CITGO Holding with respect to the dividend.[15]

Second, in October 2016—while *Crystallex I* was pending—PDVSA issued bonds as part of an exchange offer secured by 50.1% of PDV Holding's interest in CITGO Holding. The pledge issuance sought to increase existing bondholders'

participation in the exchange. On October 31, 2016, Crystallex again sued PDV Holding in the District of Delaware ("*Crystallex II*").[16] Soon thereafter, as part of a separate financing with Rosneft, PDV Holding pledged the remaining 49.9% of its interest in CITGO Holding. Although details about that financing are not public, the result of these transactions is that 100% of the equity interests in CITGO Holding is now fully pledged. *Crystallex II* includes Rosneft and PDVSA as defendants. *Crystallex I* and *Crystallex II*, together, are referred to as the "*Fraudulent Transfer Litigation*." *Crystallex II* is presently stayed until the earlier of December 29, 2017 or the Third Circuit issues its opinion in *Crystallex I*.

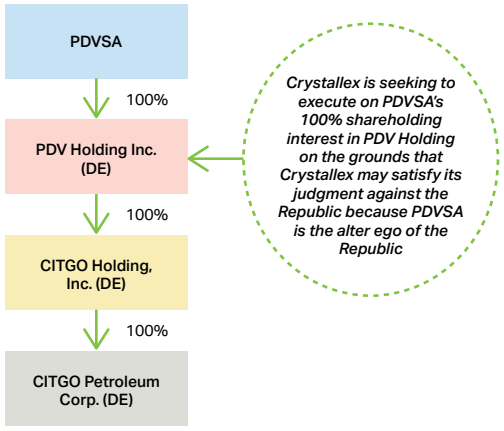
Crystallex's reliance on DUFTA to challenge these transactions ultimately will turn on whether DUFTA can be used to rescind or unwind a transaction in which the debtor (Venezuela) caused assets that allegedly would otherwise have been available for execution in the United States to be transferred to itself in Venezuela where they are not executable as a practical matter. The Court of Appeals will have to grapple with the defendant's arguments that Delaware law imposes DUFTA liability only on debtors and not on parties under an aiding and abetting and conspiracy theory. This is critical here because PDV Holding and CITGO Holding are not debtors of Crystallex nor are they alleged to be alter egos of PDVSA or Venezuela, but rather participants. Crystallex, on the other hand, sees the transaction as an integrated plan by Venezuela to cause the transfer of over $2 billion from the U.S. to Venezuela via the debt issuance and serial dividends up the chain.

In *Crystallex I* and *Crystallex II*, Crystallex alleged, but has not yet sought to establish, that PDVSA's assets are amenable to execution to satisfy a judgment against the Republic. Crystallex has teed up that issue in the *Alter Ego Proceeding* discussed below.

The Alter Ego Proceeding

As the third leg of Crystallex's litigation strategy (and the primary focus of this article) to realize on the value of CITGO to satisfy its judgment against the Republic, in June 2017, Crystallex filed a proceeding in the District Court for the District of Delaware (the "*Alter Ego Proceeding*"),[17] seeking to execute on PDVSA's 100% shareholding interest in PDV Holding on the ground that Crystallex may satisfy its judgment against the Republic by executing upon the assets of PDVSA on the grounds that PDVSA is the alter ego of the Republic. Proving its claim in the *Alter Ego Proceeding* would expand the pool of assets available to satisfy Crystallex's judgment against the Republic.

CITGO Ownership Structure (Basic)



Source for ownership structure: CITGO Information Memorandum (Public Version) for $1 bn Term Loan, dated January, 2015 (Deutsche Bank)

Crystallex's Alter Ego Allegations

For Crystallex to satisfy its judgment against the Republic out of the value of CITGO, it must prevail in the *Alter Ego Proceeding*.

The Republic and PDVSA are separate legal entities. Government instrumentalities that are set up as separate juridical entities are presumed to be independent of the sovereign states that formed them.[18] In a 1983 decision known as *Bancec*, however, the Supreme Court held that this presumption of separateness may be overcome where an alter ego relationship exists between the instrumentality and the sovereign.[19] An alter ego relationship exists where (1) the "corporate entity is so extensively controlled by its owner that a relationship of principal and agent is created," (the "Extensive Control Prong"), or (2) recognizing the corporate entity as legally separate "would work fraud or injustice" (the "Fraud or Injustice Prong").[20] If Crystallex can establish that PDVSA's relationship with Venezuela meets either of these two tests, the court will find PDVSA to be the alter ego of Venezuela and make PDVSA's assets, specifically its interest in PDV Holdings, subject to attachment to satisfy Crystallex's judgment against the Republic.

Notably, Crystallex introduced its alter ego argument as part of a motion for writ of attachment of particular property, namely PDVSA's shares in PDV Holdings. Unlike creditors in similar cases in the past, Crystallex is not seeking a universal declaration that PDVSA is the alter ego of Venezuela, but technically is seeking that decision only for the purpose of attaching

specific property.[21] This is important for two reasons. First, without an all-purpose declaration that PDVSA is the alter ego of Venezuela, the court's holding may be limited to the facts of Crystallex's case and will not necessarily benefit other creditors of Venezuela pursuing PDVSA's assets, although it could be helpful by analogy. Second, Crystallex claims to be able to establish the alter ego relationship on the basis of the evidence it has submitted, all of which was publicly available and is not under seal.[22] If it succeeds in its claim, the record will presumably provide the necessary evidence for future claimants to make similar alter ego arguments and collect Venezuela's debts from PDVSA.

Alter Ego: Extensive Control Prong

Crystallex initially argues that Venezuela exercises extensive control over PDVSA such that PDVSA is the alter ego of Venezuela. To prove extensive control, a creditor must show that the sovereign state exercises significant and repeated control over the instrumentality's day-to-day operations.[23] This inquiry is highly fact-specific, but courts focus on a few main factors including "whether the sovereign nation: (1) uses the instrumentality's property as its own; (2) ignores the instrumentality's separate status or ordinary corporate formalities; (3) deprives the instrumentality of the independence from close political control that is generally enjoyed by government agencies; (4) requires the instrumentality to obtain approvals for ordinary business decisions from a political actor; and (5) issues policies or directives that cause the instrumentality to act directly on behalf of the sovereign state."[24]

Though not an exhaustive list, these factors help the court look past "corporate formalities" in an effort to ascertain the "reality of the corporate relationship."[25] Crystallex alleges the Venezuelan government exercises significant day-to-day control over PDVSA.

First, Crystallex argues that Venezuela ignores PDVSA's separate corporate form.[26] It argues that Venezuela incorporated PDVSA to implement government policy, pointing to the "Nationalization Law" published in Venezuela's Official Gazette.[27] While indisputable, this fact alone merely demonstrates that PDVSA is a wholly owned national oil company, not that its sovereign parent exercises any amount of daily control. Crystallex also notes that there is "substantial overlap between Venezuela's government personnel and PDVSA's officers and directors," pointing to numerous news reports and public disclosures evidencing the revolving door of government and PDVSA officials.[28] However, courts have repeatedly held that the government's appointment of directors and officers, without more, is not enough to overcome corporate separateness.[29] Here, the overlap between PDVSA and Venezuelan leadership does not appear, based on the evidence presented, more significant than the control typically exercised by a sole shareholder.[30]

Additional allegations of day-to-day control center on Venezuela's allegedly close involvement in the actual operations of PDVSA. For example, Crystallex offers expert testimony and news articles explaining that government officials directly fired approximately 18,000 PDVSA employees because of the employees' opposing political views.[31] Moreover, it points out that PDVSA's business plan is based on key initiatives approved by the government, and because the government has sole control over all hydrocarbons activity in Venezuela, the government also sets PDVSA's oil production levels.[32] Crystallex highlights public disclosures PDVSA made to bondholders in which PDVSA stated that (1) Venezuela could impose material commitments upon PDVSA or intervene in and adversely affect PDVSA's commercial affairs; (2) Venezuela has required PDVSA to acquire electricity and food companies, and to divert oil production to electricity companies, affecting operations; and (3) Venezuela controls all payments the company makes to the government in the form of royalties, taxes, and dividends.[33] This level of direct government involvement in the company, Crystallex alleges, indicates that PDVSA must seek governmental approval for its daily decisions and that it lacks independence from political control over its operations.[34]

Crystallex alleges that Venezuela uses PDVSA property as its own.[35] It notes instances when Venezuela used PDVSA planes to transport government officials or foreign diplomats on government business, and points out that PDVSA and the Venezuelan oil ministry share an office building.[36] Crystallex also alleges that PDVSA paid Venezuela's arbitration costs in

the present case,[37] which the court could consider as evidence that Venezuela considers PDVSA property to be at its disposal. If, however, PDVSA introduces proof that all such uses of PDVSA funds and property were credited against PDVSA's obligation to pay Venezuela royalties for the petroleum extracted by PDVSA within Venezuela's territory, such allegations could be mitigated.[38]

Lastly, Crystallex argues that Venezuela uses PDVSA to implement government programs and policies.[39] PDVSA, it says, subsidizes the government's agricultural development projects, industrial infrastructure, and housing projects.[40] Venezuela also uses PDVSA to carry out foreign policy objectives.[41] For example, Venezuela requires PDVSA to significantly subsidize oil for certain Caribbean and Latin American countries in a program known as "Petrocaribe."[42] Petrocaribe countries repay these subsidies directly to Venezuela.[43]

Importantly, if the court decides that PDVSA is the alter ego of Venezuela under the Extensive Control Prong, other creditors could cite the same evidence in their own alter ego proceedings because such extensive control would exist irrespective of any specific relationships or interactions between the creditor on the one hand and the Republic and PDVSA on the other hand.

Alter Ego: Fraud or Injustice Prong

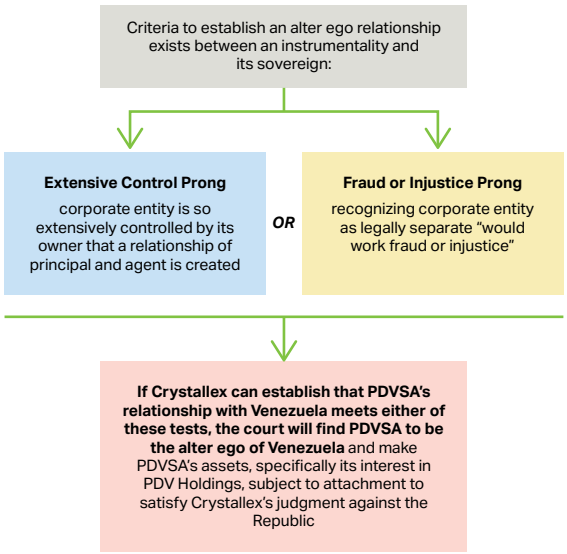
The second way that Crystallex could prove that PDVSA is the alter ego of Venezuela is by showing that "recognition of [PDVSA] as a separate entity would work a 'fraud or injustice.'"[44] In this context, courts have typically found that fraud or injustice exists only where a sovereign state is able to shield itself from liability or its assets through an abuse of the corporate form.[45] Merely avoiding payment of a legitimate judgment does not constitute the "fraud or injustice" necessary to disregard the corporate form. Unlike the extensive control analysis, the fraud or injustice inquiry tends to depend on the relationship of the judgment creditor to the alleged fraud or unjust acts. In this regard, Crystallex may be positioned to show fraud or injustice in a way that other creditors may not be able to replicate.

Crystallex argues that Venezuela gave PDVSA, by official decree and for no consideration, the very mineral rights that Venezuela expropriated from Crystallex.[46] Crystallex notes that PDVSA then sold the government 40% of the interests in the land for approximately US $2.4 billion, and that the government officially designated PDVSA the "expropriating entity" for the state, effecting numerous other expropriations with PDVSA's involvement.[47] Put differently, Crystallex argues that "Venezuela reaps enormous benefits from owning and operating an oil refining company under the protection of Delaware law, using PDVSA—a self-proclaimed 'tool' of the State—in an attempt to protect Venezuela's Delaware assets from execution."[48]

Alter Ego: PDVSA's Defenses

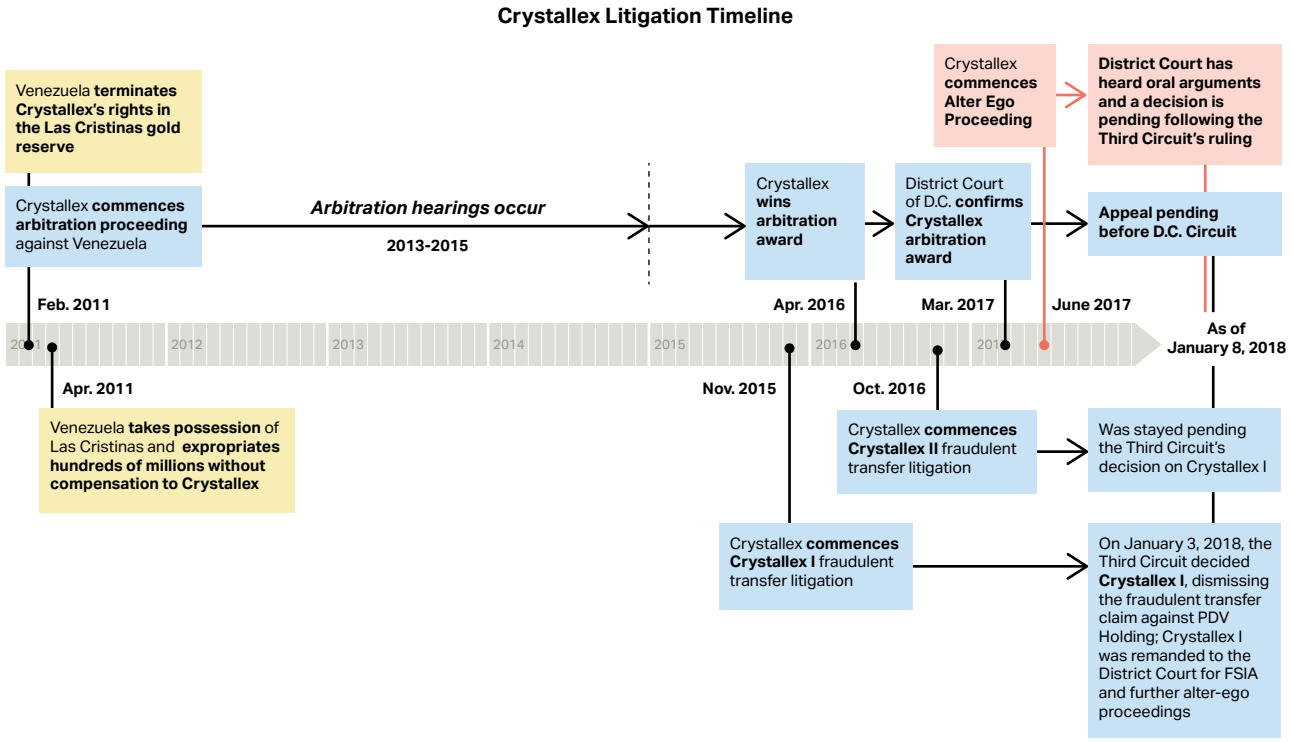
PDVSA, however, is not without defenses in the *Alter Ego Proceeding*. On November 3, PDVSA submitted its procedural defenses and opposition to Crystallex's allegations.[49] At the outset, PDVSA challenges the court's jurisdiction to enter the relief sought by Crystallex, noting that because Crystallex has no judgment against PDVSA, Crystallex must first establish that there exists an exception to PDVSA's presumptive sovereign immunity from suit under the FSIA.[50] Such a threshold jurisdictional defense may delay the ultimate resolution of Crystallex's *Alter Ego Proceeding* for some time while the court considers whether it may adjudicate the dispute as presented by Crystallex.

Keys To Alter Ego Proceeding



Additionally, even if the court determines it possesses jurisdiction, PDVSA argues that the shares of PDV Holding that Crystallex seeks to attach are themselves immune under the FSIA.[51] PDVSA correctly notes that property of a foreign state (or its alter ego) is immune unless that particular property is "*used for* a commercial activity" and not merely is commercial in nature.[52] PDVSA contends that it does not "use" its shares in PDV Holding and indeed is precluded, by official decree, from causing PDV Holding to issue dividends or otherwise transfer its profits to Venezuela or PDVSA.[53]

Aside from its immunity defenses, PDVSA also denies the substantive allegation that it is the alter ego of Venezuela, relying



on the strong *Bancec* presumption that state-owned companies' separateness should be respected, and argues that the facts Crystallex offered to show extensive control merely indicate that PDVSA is no different from a "typical government instrumentality."[54] Though it disputes the level of control exercised by Venezuela, PDVSA explains why Venezuela's transfer of the Las Cristinas property to PDVSA should not constitute a fraud or injustice on Crystallex.[55] PDVSA received the mining rights years after the expropriation underlying Crystallex's judgment and argues that any harm to Crystallex was already completed by that time.[56] Moreover, PDVSA argues that the facts of the transfer, even as framed and alleged by Crystallex, simply do not imply an "abuse of the corporate form" sufficient to justify an alter ego finding.[57] As PDVSA accurately notes, courts are reluctant to find an alter ego relationship in the absence of clear abuse of the corporate form, and Crystallex will have to clarify and emphasize PDVSA's precise role in perpetrating a fraud or injustice in order to succeed on its alter ego claim.[58]

Interestingly, PDVSA also contends that if Crystallex were successful, the only remedy it would have is to have the shares in PDV Holding sold, but that such sale is presently precluded by U.S. sanctions.

Alter Ego: Next Steps

The Delaware court—which is also hearing the Fraudulent Transfer Litigation—scheduled oral argument in the *Alter Ego Proceeding* on December 5, 2017 after Crystallex files its reply. That reply will be the first time Crystallex addresses PDVSA's FSIA arguments that both it and its shares in PDV Holding are immune.

One would expect that before deciding the fact-intensive alter ego issue, the court would first address PDVSA's FSIA arguments because they affect the jurisdiction of the court and may be dispositive even if PDVSA were the alter ego of the Republic on the basis of the evidentiary record the parties submitted. Although there is limited case law on establishing an exception to an alleged alter ego's jurisdictional immunity, those cases involve imputing a foreign state's explicit waiver of immunity to the alleged alter ego instrumentality. Here, however, the relevant exception to Venezuela's sovereign immunity was its agreement to arbitrate its claims with Crystallex under an international convention. Whether that exception applies to PDVSA, which did not agree to, and did not, arbitrate with Crystallex, is an open issue. Moreover, the actions that Crystallex contends establish that PDVSA is Venezuela's alter ego—assuming they are commercial activities—occurred in Venezuela, not in the United States. Finally, the case law imposes a strict requirement that the property to be attached in the United States be "used" for a commercial activity, such that merely holding shares may not be a "use" of those shares, whereas a pledge of shares to secure a debt would constitute a use.[59] Here, the shares in CITGO Holding were pledged as security for the 2016 bond offering, but Crystallex is seeking in the *Alter Ego Proceeding* to attach the shares of PDV Holding.

The court may also press Crystallex whether it should reach the alter ego issue if the *Fraudulent Transfer Litigation* is still pending and if indeed current U.S. sanctions would preclude Crystallex from selling the PDV Holding shares. The court has the discretion to sequence its resolution of the many issues before it, especially if Crystallex were unable to contend that the status quo with respect to the ownership of the PDV Holding shares is apt to change while the court addresses the immunity issues followed by the validity of the CITGO Holding share pledge. This is particularly so if Crystallex were to acknowledge that a favorable alter ego determination alone will not put any money in Crystallex's pocket.

Crystallex: A Roadmap for Other Creditors and Implications

Crystallex charted a course that other entities holding claims against the Republic may be able to follow. Other creditors of the Republic (and PDVSA) should pay attention to Crystallex, even though their ability to replicate any of Crystallex's success will depend largely on the specific facts and circumstances of their respective claims.

Alter Ego Proceeding

A decision that PDVSA is the Republic's alter ego under the Extensive Control Prong would carry more future risk for the Venezuelan parties because it would not rest on facts unique to Crystallex. Although PDVSA has defenses, they may be insufficient to avoid ultimate determination of whether Venezuela and PDVSA are alter egos.

A decision on the Fraud or Injustice Prong may present less cause for concern for Venezuela and PDVSA because the allegations of fraud and injustice are much stronger when made by Crystallex in this specific litigation because of the expropriation of Crystallex's valuable mining rights and their eventual transfer to PDVSA. The ability for other entities to claim a fraud or injustice will, like Crystallex's allegations, turn on specific facts applicable to such creditor. Of note, if Crystallex is unsuccessful on both prongs, then the viability of the *Alter Ego Proceeding* strategy will be called into question.

Finally, the relief sought by the *Alter Ego Proceeding* is complicated by the recent wave of sanctions imposed on Venezuela. Those restrictions include prohibitions on the purchase, directly or indirectly, by a U.S. person or within the United States, of securities from the Government of Venezuela. Although beyond this article's scope, a myriad of trading restrictions (with many exceptions) may prevent Crystallex, if successful in the Alter Ego Proceeding, from selling or transacting in the PDV Holding shares, as PDVSA has asserted.

Fraudulent Transfer Litigation

Much also hinges on the outcome of the *Fraudulent Transfer Litigation*. If Crystallex prevails in the *Alter Ego Proceeding*, then the amount it ultimately recovers will depend upon the outcome of *Crystallex I* (seeking return of the dividend) and *Crystallex II* (attacking the CITGO Holding share pledge). Even if successful in *Crystallex I*, attempting to unwind the CITGO Holding share pledge in *Crystallex II* will bring Crystallex into conflict with the bondholders holding the PDVSA 2020 bonds (that benefit from the 50.1% pledge) and Rosneft (which benefits from the remaining 49.9% pledge) that believe they possess (and, indeed, bargained for) the clearest path to realizing the shares' value. These entities have every incentive to fight Crystallex, complicating its efforts and likely increasing its costs.

Key Developments Since November 9, 2017

— Despite announced settlement with Crystallex, Venezuela failed to make first required payment, so litigation continued

— Third Circuit Ruled on Crystallex I

- On January 3, 2018, the Third Circuit dismissed Crystallex's sole remaining fraudulent conveyance claim, against PDV Holding
- The decision impedes Crystallex's ability to unwind the alleged fraudulent transfers in Crystallex I and II, but the potential to pursue PDVSA for fraudulent transfer liability as an alter ego of Venezuela remains
- For further discussion, see Richard J. Cooper and Boaz S. Morag, "Third Circuit Dismisses Crystallex's Fraudulent Transfer Claim But Potential Liability Remains for PDVSA", January 5, 2018, *available at* https://www.clearygottlieb.com/~/media/files/third-circuit-dismisses-crystallexsfraudulent-transfer-claim--cooper--morag-crystallex-dufta-3d-cir-article-1-5-2018.pdf and on the Social Science Research Network.

The Risk of a Bankruptcy Filing

The closer Crystallex gets to successfully challenging the transactions in the *Fraudulent Transfer Litigation*, the greater the risk grows of PDV Holding or CITGO Holding filing a Chapter 11 bankruptcy petition to forestall Crystallex from collecting against those entities. Although certain creditors may challenge these entities' ability to access Chapter 11 or argue that such filings would not be made in good faith, the possibility of a bankruptcy petition introduces a degree of unpredictability, litigation risk and complication that any interested party, including holders of the PDVSA 2020 bonds secured by the pledge being challenged, must consider.

Conclusion

Crystallex may be in a position to benefit from its years of work and financial investment in proving its alter ego claim. No other Venezuela creditor is likely to be in a similar position and possibly attach the shares of CITGO's indirect holding company before Crystallex. Bondholders, for the time being, are on the sidelines until a payment default occurs. As of now, although claimants holding billions in arbitral awards against Venezuela are seeking U.S. district court recognition of those awards, we are unaware of any other creditors holding final arbitral awards actively prosecuting alter ego litigation against PDVSA.

Although many hurdles remain, all Venezuela creditors should keep Crystallex in mind. Even if Crystallex gets to PDVSA's assets first, the value of the property that Crystallex attaches—if it prevails in the Alter Ego Proceeding and the Fraudulent Transfer Litigation—could be worth more than Crystallex's $1.4 billion award. At that point, the race for other creditors to follow Crystallex's lead will be on. ■

1. The text of this article was first published with the Social Science Research Network on November 9, 2017, and is available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3068455. A graphic has been included to update the reader on subsequent developments since then.
2. Managing Director and Head of Sovereign Advisory at Millstein & Co., L.P.
3. 28 U.S.C. §§ 1609-1610.
4. *See* 28 U.S.C. § 1603(b).
5. *See* 28 U.S.C. § 1603(b)(2).
6. For example, Crystallex obtained an order from the District Court for the Southern District of New York in mid-2017 preventing Nomura from selling over $700 million in securities issued by Nomura to Venezuela in 2008. It is unclear whether this freezing order will lead to a recovery for Crystallex. Crystallex obtained a separate writ of attachment from the Southern District of New York against funds placed in escrow at the Bank of New York Mellon in 1992, as part of a $315 million contract with a Mississippi shipbuilder. *See Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, No. 17-mc-00205-VEC (S.D.N.Y.). The shipbuilder contests the writ on the grounds that the funds are being held in escrow for its claims and Venezuela has no residual interest in the funds which Crystallex is seeking. *See generally* Motion to Intervene and Quash Writ of Execution, *Crystallex*, No. 17-mc-00205-VEC (S.D.N.Y. Oct. 12, 2017), ECF No. 17.
7. ConocoPhillips Co., for example, has already brought a similar claim, alleging that PDVSA is the "alter ego" of Venezuela as part of its effort to collect on an anticipated arbitral award against Venezuela. *See ConocoPhillips Petrozuata B.V. v. Petróleos de Venezuela S.A.*, Case Nos. 1:16-cv-00904-LPS, 1:17-cv-00028-LPS (D. Del.). Because Conoco does not yet have a final arbitral award, however, its case will likely remain pending until the Crystallex case is decided and Conoco's success may very well depend on that decision.
8. *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, ICSID Case No. ARB(AF)/11/2, Award (2016), http://arbitration.org/sites/default/files/awards/arb3397.pdf.
9. *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, Civil Action No. 16-0661 (RC) (D.D.C.).
10. *Crystallex*, Civil Action No. 16-0661 (RC) (Mar. 25, 2017), ECF No. 32.
11. *See Crystallex*, Civil Action No. 16-0661 (RC) (June 9, 2017), ECF No. 39.
12. The debt consisted of a secured term loan facility and secured notes, both due in 2020.
13. Case No. 1:15-cv-01082-LPS (D. Del.).
14. Del. Code Ann. Tit. 6, §§ 1301-1312 (West 2017).
15. *See Crystallex Int'l Corp. v. Petróleos de Venezuela, S.A.*, Nos. 16-4012, 17-1439.
16. Case No. 16-01007 (D. Del.).
17. *Crystallex Int'l Corp. v. Bolivarian Republic of Venezuela*, No. 17-mc-00151 (D. Del.).
18. *First Nat'l City Bank v. Banco Para El Comercio Exterior de Cuba*, 462 U.S. 611, 627 (1983) ("*Bancec*") ("[D]uly created instrumentalities of a foreign state are to be accorded a presumption of independent status").
19. *See id.* at 632-33 (an instrumentality's presumption of separateness may be rebutted by evidence establishing an alter ego relationship between the instrumentality and the sovereign state that created it).
20. *Id.* at 629.
21. Opening Brief in Support of Plaintiff Crystallex International Corporation's Motion for an Order Authorizing the Issuance of a Writ of Attachment *Fieri Facias* Pursuant to 28 U.S.C. § 1610(c), at 28 n.124, *Alter Ego Proceeding* (Aug. 14, 2017), ECF No. 3-1 ("[T]he only question on this motion is whether the specific assets sought to be attached by this motion—shares of a Delaware corporation that ultimately owns CITGO…are subject to execution.").
22. Though Crystallex believes it has submitted sufficient evidence for an alter ego finding, it requests, in the alternative, to be allowed to pursue discovery if the court finds the evidence insufficient. *Id.* In its November 22, 2017 reply, Crystallex will need to decide whether it wishes to seek discovery from PDVSA, a tactic PDVSA will undoubtedly resist, certainly while its contention that it is immune from the *Alter Ego Proceeding* remains unresolved.
23. *See LNC Invs., Inc. v. Republic of Nicaragua*, 115 F. Supp. 2d 358, 363 (S.D.N.Y. 2000) (alter-ego test requires a showing that "the government exercises extensive control over the instrumentality's daily operations and abuses the corporate form"), *aff'd, LNC Invs. Inc. v. Banco Cent. de Nicar.*, 228 F.3d 423 (2d Cir. 2000); *Seijas v. Republic of Argentina*, 502 F. App'x 19, 22 (2d Cir. 2012) (noting that *Bancec* requires extensive control of subsidiary's "day-to-day activities" or abuse of the corporate form to overcome the presumption of separateness); *EM Ltd. v. Banco Cent. de la República Arg.*, 800 F.3d 78, 91 (2d Cir. 2015).
24. *EM Ltd.*, 800 F.3d at 91.
25. *Bridas S.A.P.I.C. v. Gov't of Turkm.*, 447 F. 3d 411, 419 (5th Cir. 2006).
26. *See generally* Opening Brief in Support of Plaintiff Crystallex International Corporation's Motion for an Order Authorizing the Issuance of a Writ of Attachment *Fieri Facias* Pursuant to 28 U.S.C. § 1610(c), *Alter Ego Proceeding* (Aug. 14, 2017), ECF No. 3-1 ("Crystallex Br.").
27. *See id.* at 8.
28. Crystallex Br., at 30. Crystallex cites a presidential decree appointing PDVSA board members and officers, documents stating that the president of PDVSA served as the oil minister, and similar news reports. *Id.* at 9-10, 16-17.

29. *See Hester Int'l Corp. v. Federal Republic of Nigeria*, 879 F.2d 170 (5th Cir. 1989) ("[T]he two factors of 100% ownership and appointment of the Board of Directors cannot by themselves force a court to disregard the separateness of the juridical entities."); *EM Ltd.*, 800 F.3d at 92-93 ("The hiring and firing of board members or officers is an exercise of power incidental to ownership, and ownership of an instrumentality by the parent state is not synonymous with control over the instrumentality's day-to-day operations.").
30. In 2000, the United States Court of Appeals for the District of Columbia Circuit found that no alter ego relationship existed between Venezuela and its state-owned shipping company, even though "Venezuela (1) owned majority of [the company's] stock; [and] (2) appointed the Board of Directors and the Chairman of the Board and President." The court held that "these findings, however, describe nothing more than the sole shareholder exercising its influence." *Transamerica Leasing, Inc. v. La Republica de Venezuela*, 200 F.3d 843 (D.C. Cir. 2000).
31. Crystallex Br., at 11.
32. *Id.* at 11-13.
33. *Id.* at 12-15.
34. *Id.* at 11-16; *accord. Kalamazoo Spice Extraction Co. v. Provisional Military Gov't of Socialist Eth.*, 616 F. Supp. 660, 666 (W.D. Mich. 1985) (finding day-to-day control where the government required that all checks above a certain amount be signed by a government official, governmental agency was required to approve all invoices for shipment and the government generally exercised direct control over the instrumentality's operations).
35. Crystallex Br., at 16-17.
36. *Id.* at 9-10, 16.
37. *Id.* at 16.
38. *See Bridas S.A.P.I.C. v. Gov't of Turkm.*, 447 F. 3d 411 (5th Cir. 2006) (considering that arbitration costs for entity were paid entirely from a state fund in finding alter ego status).
39. Crystallex Br., at 17-20.
40. *Id.* at 18. PDVSA allegedly paid US $3 billion towards government housing projects. *Id.*
41. *Id.* at 20-21.
42. *Id.*
43. *Id.* at 21; *see also* Ezra Fieser, *Venezuela Gets $1.9 Billion as Dominican Republic Pays Debt*, Bloomberg (Jan 29, 2015), https://www.bloomberg.com/news/articles/2015-01-30/dominican-republic-taps-1-9-billion-to-pay-venezuelan-oil-debt.
44. *EM Ltd.*, 800 F.3d at 95; *see also Letelier v. Republic of Chile*, 748 F.2d 790, 794 (2d Cir. 1984) ("[A] foreign state instrumentality is answerable just as its sovereign parent would be if the foreign state has abused the corporate form, or where recognizing the instrumentality's separate status works a fraud or an injustice").
45. *See Bridas*, 447 F.3d at 417 (the Fifth Circuit found "fraud or injustice" sufficient to establish alter ego status where Turkmenistan dissolved a state-owned oil company that was in breach of a joint venture with plaintiff, and replaced it with an under-capitalized state-owned company, which it gave newly-enacted immunity protection); *See Kensington Int'l Ltd. v. Republic of Congo*, No. 03 Civ. 4578 LAP, 2007 WL 1032269 (S.D.N.Y. Mar. 30, 2007) (finding fraud or injustice where Congo deliberately schemed to place multiple corporate entities between oil purchasers and Congo, in order to shield Congo's assets from enforcement of liabilities).
46. Crystallex Br., at 1-3, 21-23, 32.
47. *Id.*
48. *Id.* at 32.
49. Memorandum of Law of Petróleos De Venezuela, S.A., in Support of its Cross-Motion for Lack of Jurisdiction and in Opposition to Crystallex International Corporation's Motion for Order Authorizing the Issuance of a Writ of Attachment *Fieri Facias* Pursuant to 28 U.S.C. § 1610(c), *Alter Ego Proceeding* (Nov. 3, 2017), ECF No. 26 ("PDVSA Resp.").
50. *See id.* at 9-12.
51. *See id.* at 37-40.
52. *Id.* at 37-38 (emphasis added); *accord. Af–Cap, Inc. v. Chevron Overseas (Congo), Ltd.*, 475 F.3d 1080, 1095 (9th Cir. 2007).
53. PDVSA Resp., at 40.
54. *Id.* at 25.
55. *Id.* at 22-23.
56. *Id.*
57. *Id.* at 24.
58. *Id.* at 17-20; *accord. Banco Nacional de Cuba v. Chem. Bank N.Y. Tr. Co.*, 782 F.2d 377, 380 (2d Cir. 1986) (refusing to pierce the veil where "the record reveals no devious use of the corporate form"); *Letelier v. Republic of Chile*, 748 F.2d 790, 795 n.1 (2d Cir. 1984) (stating that "abuse of corporate form must be clearly demonstrated [under *Bancec*]").
59. *Exp.–Imp. Bank of the Republic of China v. Grenada*, 768 F.3d 75, 90 (2d Cir. 2014) ("[W]e understand the word 'used,' read literally, to require not merely that the property at issue relate to commercial activity in the United States, but that the sovereign actively *utilize* that property in service of that commercial activity." (emphasis in original)); *Af–Cap, Inc.*, 475 F.3d at 1091 ("[W]e conclude that property is 'used for a commercial activity in the United States' when the property in question is put into action, put into service, availed or employed *for* a commercial activity, not *in connection* with a commercial activity or *in relation* to a commercial activity." (emphasis in original)).

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