

Third Circuit Dismisses Crystallex’s Fraudulent Transfer Claim But Potential Liability Remains for PDVSA

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On January 3, 2018, the United States Court of Appeals for the Third Circuit dealt a significant blow to Crystallex International Corporation’s long-running effort to recover its \$1.2 billion arbitral award and judgment against the Republic of Venezuela for appropriating Crystallex’s rights to the Las Cristinas gold mine. In a 2-1 decision, the Third Circuit — reversing a decision of the Delaware district court that allowed Crystallex to allege a Delaware fraudulent transfer claim against a Delaware corporation wholly owned by the Venezuelan state-owned oil company PDVSA — decided that under Delaware law, a non-debtor transferor cannot be liable for a fraudulent transfer under the Delaware Uniform Fraudulent Transfer Act (“DUFTA”).

The decision impedes Crystallex’s ability to recover the \$1.2 billion arbitral award against Venezuela from entities affiliated with the Republic, which is especially important now that the settlement recently announced in November 2016 between Crystallex and Venezuela that would have ended Crystallex’s judicial enforcement efforts appears to have collapsed after Venezuela failed to make the first settlement payment. However, the appeals court decision does leave Crystallex able to pursue a DUFTA claim against PDVSA, if Crystallex can demonstrate that PDVSA is debtor Venezuela’s alter ego—an issue that Crystallex has already raised and argued in a separate pending proceeding against PDVSA in Delaware district court (the “Alter Ego Litigation”) in which the Court heard arguments on December 21, 2017.

What does this all mean for holders of Venezuelan debt? For PDVSA’s secured 2020 bondholders, the decision is welcome news, and makes the chances of any of those transactions being unwound and the liens granted to 2020 bondholders set aside even more remote. While Crystallex’s chance at a recovery against PDVSA or its assets remains alive if they are successful in their alter ego claims, PDVSA 2020 bondholders can rest easier after the decision that they will retain their liens and priority to any proceeds from a sale of their collateral ahead of Crystallex or similar claimants even if such claimants successfully pursue their alter ego claims against PDVSA. For other Republic creditors considering a similar strategy as Crystallex, the chances of jumping ahead of the 2020 secured PDVSA bonds or even debt below PDV Holding just got less likely, and with each passing day of litigation, the challenge of collecting any award from the cash-strapped nation only increases.

Crystallex’s DUFTA Claim and the District Court Decision

In late 2014 and early 2015, CITGO Holding, the parent company of valuable CITGO Petroleum Corporation, issued approximately \$2.8 billion in non-investment grade debt and paid a dividend of approximately \$2.8 billion to PDV Holding (its parent company). PDV Holding then paid PDVSA (its parent, in Venezuela) a dividend in approximately the same amount. The

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alleged net effect of these transactions was to send nearly \$3 billion from the United States to Venezuela and saddle CITGO Holding with a nearly equivalent amount of debt.²

Sensing an effort by Venezuela to avoid payment on its forthcoming arbitral award, in November 2015 Crystallex filed a lawsuit in the District of Delaware (“*Crystallex I*”) against the three entities allegedly involved in the issuance of the debt and dividend payments — PDVSA, PDV Holding and CITGO Holding — alleging DUTSA violations and seeking to unwind the transactions.³ The lawsuit alleged that PDVSA is Venezuela’s alter ego and that PDVSA’s assets in the United States — including PDVSA’s now-encumbered interests in CITGO Holding — therefore should be available to satisfy any arbitral award issued against Venezuela.

Crystallex I sought the return to the United States of the billions sent by Delaware corporation PDV Holding to PDVSA in Venezuela as a remedy for the violation of the DUFTA provision that:

A transfer made or obligation incurred by a debtor is fraudulent as to a creditor, whether the creditor’s claim arose before or after the transfer was made or the obligation was incurred, if the debtor made the transfer or incurred the obligation . . . [w]ith actual intent to hinder, delay or defraud any creditor of the debtor.⁴

Crystallex’s DUFTA claim alleges that CITGO Holding was forced by PDV Holding and PDVSA to incur obligations (the \$2.8 billion in debt) and then transfer those proceeds to PDV Holding, which then transferred proceeds to PDVSA, in a series of fraudulent dividends that placed the funds beyond the reach of Crystallex’s collection efforts in the United States.

In response, PDV Holding and CITGO Holding argued in their motion to dismiss that Crystallex’s allegations against them did not meet the statutory requirements for a DUFTA claim, principally because neither PDV Holding nor CITGO Holding was a “debtor” under DUFTA as Crystallex concededly possessed no claim against either of those entities.

On September 30, 2016, the district court declined Crystallex’s invitation to analyze the series of transactions as a single transfer, deciding that CITGO Holding was not part of any alleged fraudulent transfer of an alleged debtor’s (*i.e.*, Venezuela’s or PDVSA’s by virtue of the alter ego allegations) property and therefore could not have participated in any fraudulent

² For more detailed background on the various Crystallex proceedings and Crystallex’s efforts to recover from PDVSA on an alter ego theory of liability, see Richard Cooper and Boaz Morag, “Venezuela’s Imminent Restructuring and the Role Alter Ego Claims May Play in this Chavismo Saga,” SSRN (Nov. 9, 2017) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3068455.

³ *Crystallex Int’l Corp. v. Petróleos de Venezuela, S.A.*, Case No. 1:15-cv-01082-LPS (D. Del.). 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*”), Case No. 16-01007 (D. Del.). 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 and was stayed until the Third Circuit issued its opinion in *Crystallex I*.

⁴ 6 Del. C. § 1304.

transfer under DUFTA. PDV Holding, however, presented a different situation because it was alleged to have participated in the fraudulent transfer to PDVSA as a “direct party” and a “non-debtor transferor of debtor property” — even though PDV Holding was not a debtor to Crystallex. PDV Holding sought immediate appellate review of the denial of its motion to dismiss and the Third Circuit agreed to hear the appeal.

In a separate decision issued on May 1, 2017, the district court dismissed PDVSA from *Crystallex I* because PDVSA is presumptively immune from suit in the United States as an instrumentality of a foreign state under the Foreign Sovereign Immunities Act of 1976 (the “FSIA”), and Crystallex tried, but failed, to allege an exception to PDVSA’s immunity. Although the district court held that Crystallex’s cause of action against PDVSA rested upon its “commercial activity” (i.e., the transfers), an exception to FSIA immunity, Crystallex failed to allege that PDVSA’s commercial activity was “carried on in the United States.” Crystallex sought leave to file an amended complaint that it claims cures this FSIA-deficiency and alleges that PDVSA took steps in the United States to orchestrate the transfers. The district court stayed consideration of the motion to amend pending the resolution of the Third Circuit appeal on the DUFTA issue.

The Appeal and Third Circuit Decision

The Third Circuit accepted PDV Holding’s argument that the district court erred when it held that DUFTA extends to transfers by non-debtors like PDV Holding. The court noted that to survive a motion to dismiss under DUFTA, a plaintiff must “successfully plead three things: (1) a transfer, (2) by a debtor, (3) with actual intent to hinder, delay, or defraud a creditor.” Decision at 10. PDV Holding’s appeal, the court said, “turns on the meaning of the second element, ‘by a debtor.’” *Id.* In a precedential, 2-1 panel decision, the Third Circuit held that “transfers by non-debtors are not fraudulent transfers under DUFTA.” Decision at 9. The Third Circuit reversed the district court order and remanded for further proceedings.

In reaching its decision, the Third Circuit relied on a plain reading of DUFTA and a series of Delaware Chancery Court cases that the majority found suggested that non-debtor transferors cannot violate DUFTA. Applying this rationale to Crystallex’s complaint, only Venezuela and PDVSA (by virtue of the alter ego allegations against PDVSA) were alleged to be “potential debtors” possibly liable for the transfer of property in the allegedly fraudulent scheme alleged in Crystallex’s complaint. Decision at 11. Accordingly, a DUFTA claim could only exist against Venezuela and PDVSA — not non-debtor PDV Holding (nor non-debtor CITGO Holding).

The Third Circuit declined to disregard corporate form and consider PDV Holding as PDVSA (or Venezuela) where Crystallex had failed to allege that “PDV[Holding] is Venezuela’s or PDVSA’s alter ego or any other basis on which [the court] could pierce the corporate veil.” Decision at 15. The majority also refused to expose PDV Holding to DUFTA liability on account of (i) DUFTA’s “broad remedial purpose”; (ii) equitable considerations; Decision at 18; or (iii) an “aiding and abetting” theory of DUFTA liability, Decision at 21.

The dissenting opinion would have affirmed the district court’s decision and allowed Crystallex to proceed with a claim against non-debtor PDV Holding. The dissent distinguished

the Delaware cases in which the majority rooted its opinion, cited PDV Holding’s role as an alleged “direct participant in the fraudulent transfer,” Dissenting Op. at 3, and viewed the alleged transfers as an “*indirect* transfer ‘by a debtor’”—i.e., as part of a scheme concocted by debtor Venezuela. *Id.* at 8.

Possible Next Steps

Although the decision complicates Crystallex’s ability to prosecute a DUFTA claim against PDV Holding, Crystallex is not without further litigation options. It may seek review of the panel’s decision, or whether or not a rehearing is sought, may return to the district court to request permission to pursue the amended complaint against PDVSA.⁵

- *Route 1 - Seeking Third Circuit En Banc Review.* Four federal judges have considered whether non-debtor PDV Holding may be liable under DUFTA. Two answered yes; two answered no. Given the close arguments on both sides, and the fact that the Third Circuit is deciding an unresolved issue of Delaware law, it is possible that Crystallex could seek *en banc* review of this decision by the full Third Circuit which would then have the option of considering whether to certify this unresolved question of Delaware law to the Delaware Supreme Court.⁶
- *Route 2 – Litigating Crystallex’s DUFTA Claim Against PDVSA Before the District Court.* Crystallex’s claims against PDVSA are not yet extinguished because the Third Circuit recognized that although “PDVSA was not involved in the arbitration proceeding . . . if we accept as true Crystallex’s allegation that PDVSA is the alter ego of Venezuela, it is at least theoretically possible that PDVSA could be liable for the arbitration award as well.” (emphasis added). Decision at 11 n.7. An alter ego finding would make PDVSA a “debtor” for DUFTA purposes, thus satisfying the DUFTA standard set out in the Third Circuit’s decision. Therefore, in further proceedings before the district court, consideration of whether to permit Crystallex to proceed with its amended DUFTA complaint against PDVSA and the complaint’s merits would likely be decided.⁷

⁵ Following Crystallex, another Republic arbitral award holder, ConocoPhillips Inc., filed a similar DUFTA suit against PDVSA, PDV Holding and CITGO Holding, which was stayed by the Delaware district court pending the Third Circuit appeal. ConocoPhillips will now need to decide whether to proceed with its DUFTA claims against PDVSA and whether it may avail itself of an alter ego finding in the Crystallex Alter Ego Litigation would such finding be made in that case.

⁶ In two recent cases, the Third Circuit has agreed to hear *en banc* decisions in which the judge who dissented in *Crystallex* had also dissented.

⁷ Although demonstrating that PDVSA and Venezuela are alter egos would make PDVSA’s assets available to Crystallex to satisfy its judgment against the Republic, on the one hand, treating the two as a single entity is likely to complicate Crystallex’s efforts to show that an improper transfer of debtor property took place, on the other. Crystallex may be harder pressed to show that the proceeds raised by the dividend (and the challenged share pledges in *Crystallex II*) by PDVSA corporate subsidiaries were improperly used to finance the operations of the Republic if PDVSA and the Republic share assets and liabilities.

- Step 1 – The district court must decide whether to permit Crystallex to amend its complaint.
 - As it currently stands, the district court has dismissed Crystallex’s DUFTA claim against PDVSA because of PDVSA’s FSIA immunity and Crystallex’s failure to allege that PDVSA undertook a commercial activity in the United States that would overcome that immunity. Crystallex, however, has pending a motion to amend its complaint to allege additional facts that strengthen Crystallex’s claim that PDVSA’s commercial activities in the United States overcome any immunity.
- Step 2 – Crystallex must then demonstrate that PDVSA is Venezuela’s alter ego.
 - If it can establish jurisdiction over PDVSA, Crystallex then would need to establish that PDVSA is Venezuela’s alter ego and therefore liable for the \$1.2 billion arbitral award entered against Venezuela in Crystallex’s favor and thus a “debtor” for DUFTA purposes.
 - The district court has not indicated when it will issue a decision in the Alter Ego Litigation following the hearing it held on December 21, 2017. Given the Third Circuit’s decision, the logical sequence for the district court to follow is to address the jurisdictional issues PDVSA has raised and then consider the merits of the alter ego argument. If PDVSA is found to be the alter ego of the Republic then Crystallex will have a choice whether even to pursue the DUFTA claim since the alter ego finding would, under Crystallex’s view, entitle it to attach PDVSA’s shares in PDV Holding, an asset which may well satisfy its judgment. Sanctions imposed by the United States government may affect whether Crystallex can execute upon the PDV Holding shares.
- Step 3 – Crystallex must demonstrate that PDVSA is liable under DUFTA. If Crystallex chooses to pursue the DUFTA claim against PDVSA with respect to the dividends sued on it will need to prove the other elements of a DUFTA claim. This will involve, among other requirements, proving that a transfer of the debtor’s property (*i.e.*, a transfer of the dividended funds from PDVSA to a third party or from the Republic to a third party) occurred. Crystallex may be well on its way, as the dissenting judge for one believed that Crystallex stated all the elements of a DUFTA claim and was “the victim of a purposeful and complicated fraud.”

Conclusion

The Third Circuit's decision puts up a roadblock to Crystallex's efforts to unwind the allegedly fraudulent transfers that it believes are frustrating its chances to recover on its \$1.2 billion arbitral award against Venezuela, but it is not out of options. For existing holders of PDVSA bonds, the decision definitely delays and likely reduces the risk (to the extent one existed) that Republic bondholders will be able to recover from PDVSA cash flows or assets when it comes time to seeking recovery on their claims. Without doubt, the decision also makes the unwinding of any previous grant of collateral, such as to the 2020 Secured PDVSA bonds, unlikely. Most importantly, as the economic situation in Venezuela continues to deteriorate and the number of Venezuelan bond defaults continues to mount, the Third Circuit's decision is a poignant reminder about the challenges of recovering on claims against a determined sovereign willing to defend its position.