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# Emerging Markets Restructuring Journal

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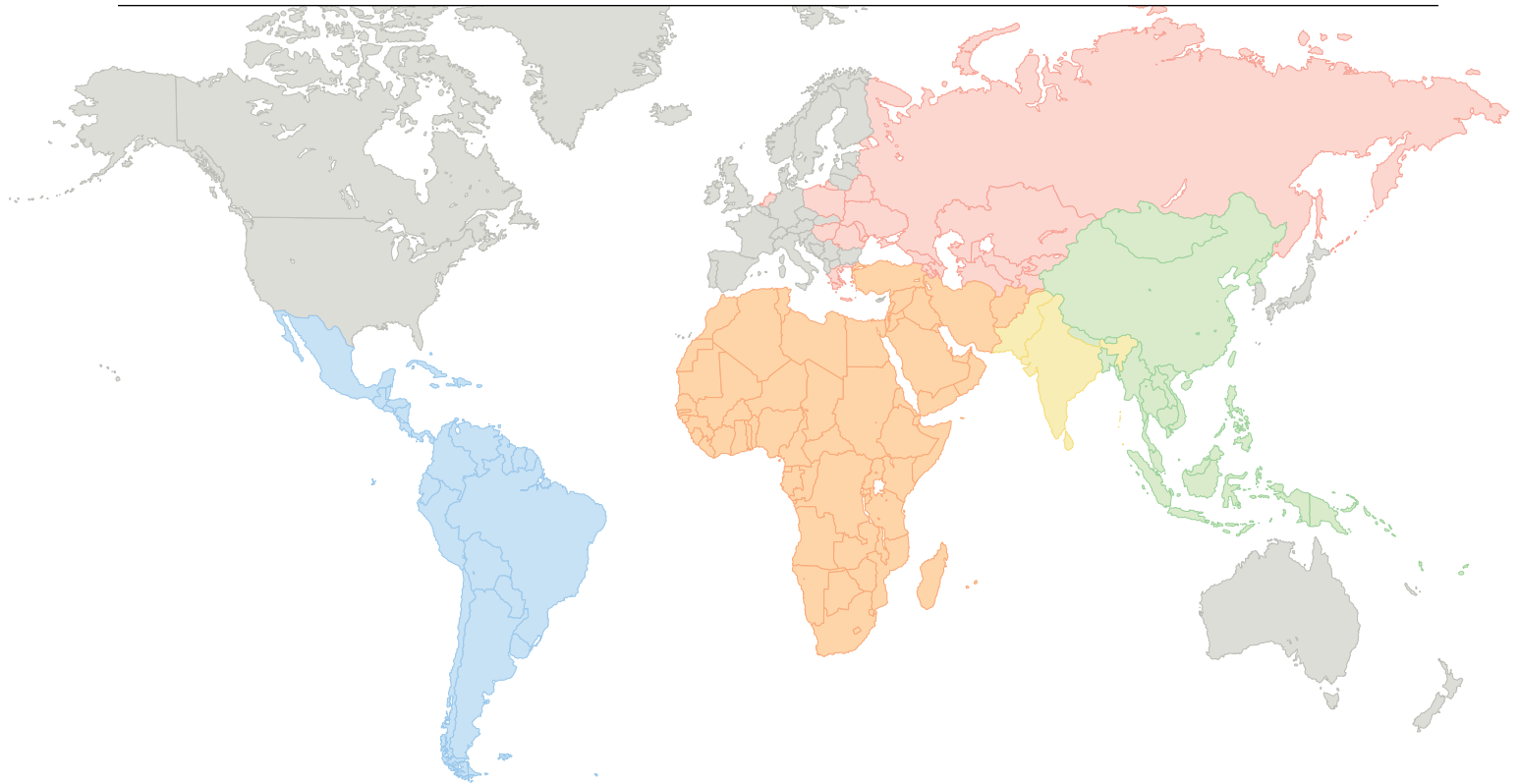
ISSUE NO. 5 — WINTER 2017-2018





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# Letter from the Editors



During the September emerging markets conference organized by Cleary Gottlieb in London, some of the major themes discussed across the board were the political instability and the frequent feature of unexpected events (and correlated risks) within many of these markets, as well as the looming Venezuela economic crisis. Restructuring practice in emerging markets has been bursting with activity and news this year, and so have we, increasing the journal's production from bi- to tri-annual, thanks to our contributors and to the constant flow of new content we strive to keep up with.



The wave of corruption scandals started with the Lava Jato investigations in Brazil and sweeping throughout Latin America continues to have repercussions in the region, from bankruptcy filings to an uptick in distressed M&A transactions. Fittingly, our first featured article in this issue of the journal addresses ways of minimizing FCPA risk when investing in Brazil.



On the legislative news front, considering how important the Netherlands often is to emerging markets restructurings as jurisdiction of choice for financial subsidiaries, we highlight a recent interesting development in Dutch insolvency laws providing for a tool to bind holdouts without the need to go through a formal insolvency proceeding. Also, continuing our coverage of NPL issues, we offer an overview of recent regulatory changes in Ukraine that facilitate the structuring of these types of distressed investments.



No matter how great the legislative innovations (or lack thereof), only real case studies can show how well a restructuring regime is holding up. Our Chilean contributors explore how the 2014 Chilean bankruptcy reform allowed for successful in-court restructuring proceedings in a country where until recent times the only outcome of a bankruptcy filing was liquidation. Moving to the Middle East, we feature an analysis of the current Dana Gas dispute that is testing the limitations of the Islamic Sharia-compliant bonds (sukuk). In Nigeria, we look at an unsuccessful attempt to restructure a major telecommunication company via a debt-to-equity conversion with lessons learned and takeaways on the strengths and weaknesses of this restructuring tool in Nigeria. Another case we are following closely is the U.S. Chapter 15 proceeding of the International Bank of Azerbaijan that could test the limits of enforcing a foreign restructuring plan in the U.S.

Last but certainly not least, with President Nicolas Maduro announcing the much anticipated restructuring of Venezuelan debt on November 3, we present an article on the potentially groundbreaking alter ego claims in the ongoing Crystallex/PDVSA litigation that, if successful, may unleash a flood of creditors following Crystallex's lead to attach PDVSA's assets.

We hope you find the contributions in this issue interesting and useful to your practice, and as always, we encourage your comments, questions and, of course, submissions for our next issue.

**Polina Lyadnova, Adam Brenneman, Sui-Jim Ho and Denise Filauro**

# Investors, Brazil and the FCPA: Minimizing M&A Risk in the Wake of Lava Jato

By: LISA VICENS and KATE CURRIE



The recent uptick in the mergers and acquisitions market in Brazil comes at a time of great upheaval in Brazil. Brazil’s sweeping anticorruption investigation, which is more than three years old, has resulted in more than 844 search and seizure warrants, 201 arrest warrants, 158 whistleblower agreements, and 10 corporate settlements (known in Brazil as “leniency agreements”) with some of the largest companies in Brazil. Some companies implicated in the scandal have been forced to restructure or file for bankruptcy as a result of their involvement.

Given the active role of Brazilian authorities and the expansive nature of the Foreign Corrupt Practices Act (the “FCPA”), the U.S. legislation that prohibits corrupt payments to non-U.S. government officials, investors need to be mindful of their approach to acquisitions where the targets may be connected

to the corruption scandals. This issue is particularly present in “distressed” acquisitions, where one of the sources of distress has been corruption-related terminations of government contracts or other consequences flowing from allegations of corruption.

Fortunately there is a well-worn path, informed by past settlements as well as guidance from U.S. regulators, that helps investors either avoid buying tainted companies or lessen the risk of exposure to corruption-related liability when making investments in tainted companies. To avoid or reduce these risks, investors need to be aware of and plan for circumstances unique to the Brazilian context. Appropriate diligence and early planning can help to minimize the risks and capitalize on the opportunities presented by the Brazil M&A market.

## Overview of the FCPA

### FCPA

Enacted in 1977, the FCPA is the *most* vigorously enforced foreign anti-bribery legislation in the world. It casts a wide net and can potentially lead to actions by U.S. authorities related to the purchases of targets abroad that have been tainted by bribery. Unlike many foreign bribery laws, the FCPA has two potential sources of liability.

#### FCPA Sources of Liability

- An anti-bribery provision that prohibits corrupt payments of anything of value to a foreign official in order to obtain or retain business or for an improper purpose. This provision requires that the illicit payment have a U.S. nexus, such as a U.S. person or company making the bribe, the parties acting in furtherance of the bribe within the U.S., or, for U.S. issuers, the bribery occurring in connection with U.S. interstate commerce.
- “Accounting” provisions, which require *any* issuer of securities listed in the U.S. to maintain accurate books and records *and* to maintain a system of internal controls sufficient to provide reasonable assurance that corporate assets are used only for authorized purposes and that an issuer is able to prepare financial statements according to appropriate accounting standards. Importantly, an issuer may be liable under these provisions for inaccuracies in the books and records of a subsidiary and for failing to maintain appropriate internal controls that prevent bribery in a subsidiary.

The accounting provisions, in particular, are often the hook through which foreign issuers are found liable for FCPA violations. A bribe by a foreign issuer is invariably intentionally falsely recorded on its books, leading to accounting provision liability regardless of any U.S. contacts (other than its issuer status) or the materiality of the false record.

The Department of Justice (the “DOJ”) and the U.S. Securities and Exchange Commission (the “SEC”) are responsible for enforcing the FCPA and have a wide array of tools at their disposal to do so, including fines, disgorgement of ill-gotten gains, and the power to impose non-monetary penalties, such as debarment and the appointment of a compliance monitor. U.S. regulators have also developed programs to encourage the voluntary disclosure of potential corrupt acts, with the promise of lower fines or even the possibility that prosecutors would decline to prosecute the illicit activity, as a reward for cooperating with authorities.

### Successor Liability

Generally, under U.S. law buyers are not liable for pre-acquisition crimes of the target, but an acquisition cannot extinguish the pre-close liability of the target.<sup>1</sup>

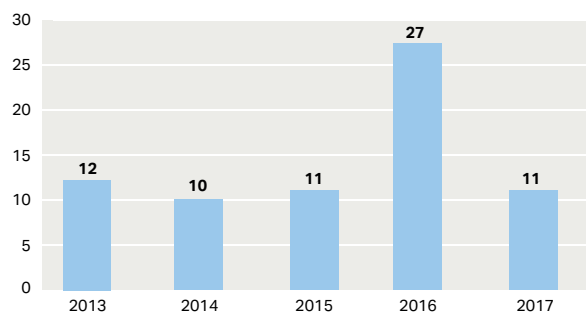
#### The standard corporate rules of U.S. successor liability apply in the FCPA context

- A purchaser that purchases the stock of another company and maintains such company as a subsidiary does not assume liability for pre-acquisition violations by the subsidiary; liability remains with the newly-acquired subsidiary.
- Absent fraud or an asset sale that is essentially the purchase of an entire company, a company that purchases the assets of another does not assume liability for any pre-acquisition violations by the seller; liability remains with the seller.
- In a merger between two companies, the surviving entity assumes liability for any violation committed by either company prior to the merger.

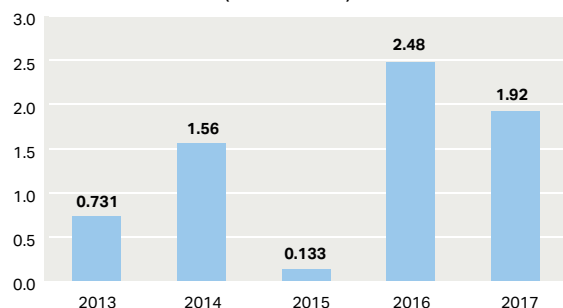
If a target committed bribery but there was no FCPA liability at the time the bribe occurred, an acquisition of the target by a U.S. company does not retroactively create FCPA liability for that bribe. As stated in 2012 guidance from the DOJ and the SEC, “Successor liability does not...create liability where none existed before.” (Of course, there may be continuing liability for the target under any local anti-bribery law.)

Thus, if there is a concern that a target may be tainted by the recent Brazilian corruption scandals, buying assets is likely the safest approach; and a merger the riskiest strategy. While other business concerns will generally outweigh any corruption issues, in certain transactions, structuring the transaction with these principles in mind may help contain or avoid FCPA liability.

Number of Companies Paying to Resolve FCPA Cases



Source: <http://www.fcpablog.com/blog/2018/1/2/2017-fcpa-enforcement-index.html>

Amount Paid By Companies to Resolve FCPA Claims  
(USD Billions)

Source: <http://www.fcpablog.com/blog/2018/1/2/2017-fcpa-enforcement-index.html>

## Mitigating the Risks of Acquiring Assets Tainted by Corruption

### The Importance of Effective Diligence

An investor's primary line of defense is due diligence. In addition to protecting a company against risk, effective pre-acquisition due diligence can also ensure proper valuation and post-acquisition planning. Indeed, the DOJ and SEC have consistently advised companies to perform thorough due diligence as a defense against an enforcement action and have declined to prosecute pre-acquisition conduct where the buyer performed adequate diligence, disclosed any violations and took remedial measures post-close.<sup>3</sup> In a 2002 opinion, the DOJ laid out the steps a company should take during its due diligence pre- and post-close:

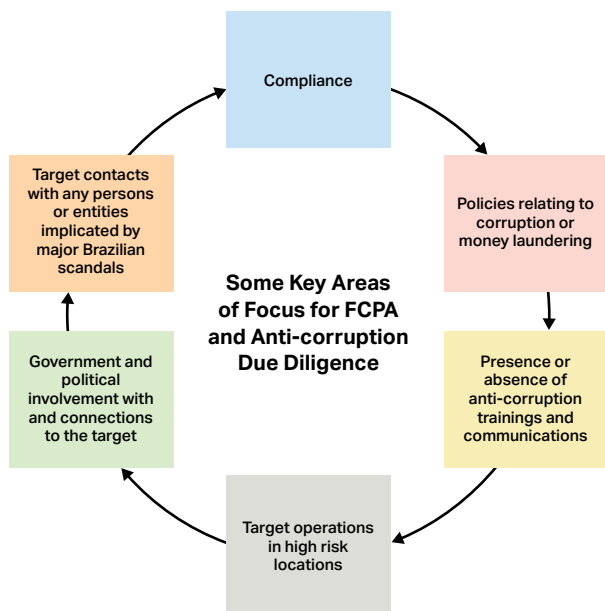
- conduct thorough risk-based FCPA and anti-corruption due diligence;
- implement the acquiring company's code of conduct and anti-corruption policies as quickly as practicable;
- conduct FCPA and other relevant training for the acquired entity's directors and employees, as well as third-party agents and partners;
- conduct an FCPA-specific audit of the acquired entity as quickly as practicable; and
- disclose to the DOJ any corrupt payments discovered during the due diligence process.

Regarding the last point, actual disclosure to U.S. authorities should only be made after a careful assessment of the risks and benefits associated with any such disclosure.

In general, a diligence plan should be risk-based, with enhanced diligence for higher-risk transactions. For example, deals in which the target is part of a corporate structure in which a related company has been prosecuted or is being investigated for corrupt payments demand more expansive diligence efforts. An enhanced diligence plan could include:

- document requests going back five years (the FCPA statute of limitations);
- interviews of key senior officials with knowledge of the risks and the company's response to such risks;
- an assessment of any existing compliance program; and
- where applicable, updates on the progress and findings of any internal investigations relating to bribery or corruption carried out by the target or seller.

Investors should also consider engaging support firms, such as forensic accounting firms (which can review internal controls and high-risk transactions), reputational diligence firms (which can review sanctions lists, debarment lists, and media reports), investigative firms (which can conduct discreet inquiries), and business intelligence firms (which can examine strategic risk or political concerns). Many forensic accounting firms based in Latin America have developed extensive knowledge of *Lava Jato* and know what to look for, including known intermediaries for corrupt payments.<sup>3</sup>



### Minimizing Risks Through the Transaction Agreement

In addition to conducting diligence, an investor should also contractually protect itself with anticorruption contract terms. While even the best contract terms are not a defense to FCPA liability, they can push sellers to disclose corruption incidents or investigations and compliance weaknesses. Typically, these provisions include FCPA-specific representations and warranties in the acquisition or asset purchase agreement. While some terms are relatively common, there is considerable variation in the scope of these representations and they may be heavily negotiated.

### Sample Anti-Corruption Representation

“Neither the Company or its Subsidiaries, nor any director nor, to the Knowledge of the Company, any agent or other person acting on the Company’s behalf has (i) used any corporate funds for any material unlawful contribution, gift, entertainment or other material unlawful expense relating to political activity; (ii) violated the Foreign Corrupt Practices Act of 1977, as amended, or the Brazilian Clean Company Act or made a material violation of any other applicable anti-bribery or anticorruption law; or (iii) made, offered, agreed, requested or taken an act in furtherance of any material unlawful bribe or kickback or other unlawful or improper payment or benefit. The Company and its Subsidiaries have instituted, maintain and enforce, and will continue to maintain and enforce, policies and procedures designed to promote and ensure compliance with all applicable anti-bribery and anticorruption laws.”

### Key Considerations For Buyers In Evaluating FCPA Representations In Contracts

- Whether compliance with corruption laws representations are materiality qualified;
- Whether compliance with corruption laws representations are knowledge qualified and, importantly, how “knowledge” is defined (e.g., the knowledge of every employee of the target, the knowledge of a select group of target executives, knowledge of the sellers, knowledge after due inquiry);
- How far back in time a corruption representation covers (the FCPA statute of limitations is five years but U.S. authorities, using conspiracy or other theories of liability, have extended that limitations period considerably); and
- Whether the target has a compliance program or internal controls that will alert them to possible violations (i.e., the representations may be given in good faith by management or the sellers, but may be inaccurate if they have little knowledge of potential bribery by front line employees).

### Suggested Enhanced Contractual Protections Where There Is Already Evidence of Corrupt Activity

- Requiring the target to conduct an internal investigation and take remedial action (e.g., repudiate tainted contracts and return tainted profits, fire the employees involved, implement compliance measures that address the misconduct);
- Requiring the target to report any inappropriate conduct to the appropriate authorities and settle with authorities prior to close;
- Insisting on material adverse change or condition precedent clauses, specific to the risks, that allow the purchaser to walk away from the transaction with little to no penalty if the target cannot satisfactorily resolve the matter in a reasonable period or an investigation reveals a material problem; and
- Inserting indemnification provisions that would apply to losses related to potentially corrupt payments that are incurred after the transaction is concluded.



Because provisions relating to FCPA compliance require the counterparty to take on more risk, they are more difficult to negotiate, but acquiring companies have been able to obtain such provisions in past deals. There are, however, downsides to these tactics. For example, further investigations and negotiating corporate settlements can cause delays that could last years; reporting a matter to enforcement authorities introduces uncertainty into a transaction; and an indemnification provision is only as good as the buyer's ability to collect on or enforce the provision.

## Planning for and Understanding Continuing Risks

### Safeguarding Against Post-Acquisition Violations

It is best to have a post-acquisition compliance and remediation plan in place as early in the process as possible. Generally, if a buyer conducts appropriate pre-close diligence and engages in prompt remediation following the close, U.S. authorities are likely to use their discretion not to bring an enforcement action for any bribes undertaken by the target during an understood grace period. (The length of that grace period is often around six months, though it can vary.) If, however, the buyer is directly involved in the target's bribery (pre- or post-close), the buyer fails to conduct reasonable diligence and post-close remediation, or post-close bribery continues well past the closing, the buyer and/or the target may face liability (depending upon the parties involved in the bribery and the FCPA jurisdiction over that conduct). Indeed, the DOJ and SEC warn

that they are more likely to prosecute a successor company where it "directly participated in the violations or failed to stop the misconduct from continuing after the acquisition." In fact, three of the five steps that the DOJ has advised acquiring companies to undertake (from its 2002 opinion and outlined above) relate to *post*-acquisition efforts.

The risks for FCPA issuers are particularly acute. Technically, if a bribe is made by the target on the day after the closing and it is falsely entered into the target's books (e.g., a bribe intentionally mislabeled as a "commission") and the buyer is an FCPA issuer, the buyer would be liable under the FCPA accounting provisions – even if the buyer knew nothing about the bribe. In addition to ensuring no bribery payments are made going forward, an acquiring company should be mindful to remedy possible books and records violations stemming from pre-acquisition conduct.

### Continuing Obligations Associated with Pre-Acquisition Violations

Where a target settles with authorities for FCPA violations prior to a transaction, the acquiring company likely will have to assume the obligations associated with that settlement. This does not mean that the buyer assumes FCPA liability but, for example, often requires the acquiring company to undertake any remediation efforts the target company agreed to as part of its resolution. For instance, in 2014, Alstom S.A. entered into a plea agreement admitting to FCPA violations, shortly after General Electric's purchase of the core of Alstom's assets was approved. The agreement required General Electric to

undertake certain obligations in the plea agreement, including putting in place a detailed compliance program and complying with specific reporting requirements. Therefore, any investor looking to acquire a target involved in settlement discussions will want to be kept apprised of the settlement negotiations, to understand what obligations it may ultimately have to carry out.

## Global Considerations

### Global Anticorruption Efforts

While this article is focused on the FCPA, investors should also be aware of the ever-expanding web of anticorruption statutes, including Brazil's anticorruption legislation, the Clean Company Act, which became effective in 2014. In this shifting landscape, regulators are increasingly coordinating across borders to investigate and prosecute corrupt conduct. For instance, in December 2016, Odebrecht and Braskem resolved bribery-related charges simultaneously with authorities in the U.S., Brazil and Switzerland, and in January 2017, Rolls Royce settled charges of bribe payments against it simultaneously with the U.S., Brazil and the U.K. This increased level of cooperation has four primary consequences for any acquiring investor.

#### Consequences of Cross-Border Cooperation

- It may shift of the calculus further in support of voluntarily disclosing potential misconduct. Self-reporting may, in certain jurisdictions such as the U.S., lead to leniency, and global settlements such as those described above allow the settling companies a degree of finality.
- On the other hand, cross-jurisdictional cooperation increases the risk that authorities in one country will learn about the misconduct from authorities in another country. Thus, the cost of self-reporting may increase as it may create enforcement actions in several jurisdictions.
- It may require interested investors to educate themselves on a larger set of anticorruption statutes and potential exposure related thereto.
- It may result in increased penalties for any corrupt activity, as well as the diversion of resources (and associated financial costs) that necessarily accompany any governmental investigation into the conduct.

The benefits of an effective diligence and compliance plan that addresses anticorruption risks becomes even more critical in the context of cross-border investigations.

## Considerations in the Current Brazilian Context

Given the amount of public information relating to bribery coming out of Brazil, U.S. authorities will assume that acquiring companies are on notice about that information and investigating it appropriately. For instance, leniency agreements, guilty pleas and search and seizure petitions are publicly available in Brazil and provide detailed information outlining corrupt conduct. An investor will want to review all public documents to understand what allegations might exist specifically relating to the target. Cooperator statements, which are generally publicly available once a leniency agreement has been approved by the relevant Brazilian court, provide more granular details about the particular contracts or assets that have been tainted by bribery and can help a prospective buyer evaluate which assets are clean and less likely to result in anticorruption liability. A buyer that has not considered these sources of information may be viewed by U.S. officials as having failed to perform adequate diligence.

Given the scope of the Clean Company Act, an acquiring company should first understand whether the target is related to any company that has been implicated in any of the Brazilian anticorruption investigations, including *Lava Jato*, and may therefore have exposure under the Clean Company Act. The Clean Company Act imposes civil and administrative liability on companies operating in Brazil for domestic and foreign bribery. Under the Clean Company Act, controlling, controlled and affiliated companies can be held jointly and severally liable for any fine or damages imposed for a bribe paid by a related company. Therefore, if the target falls within the corporate structure of a company implicated in the Brazilian anticorruption investigations, that target might be financially responsible, even if the target itself has not paid any bribes. Moreover, that liability continues, in the case of a merger, spin-off, change of corporate form or contractual amendment.<sup>4</sup> The law provides limited protection, provided there is no fraud, by capping successor liability at the value of the transferred assets.

The risk of joint and several liability is particularly acute in the current Brazilian market. Given the number of companies subject to leniency agreements or otherwise under investigation that have declared bankruptcy or are restructuring, there is a much higher risk that a potential target may need to pay the financial penalty incurred by an insolvent member of the

corporate family that engaged in bribery. For instance, both Odebrecht and Camargo Correa, which entered into leniency agreements, are restructuring and selling their interests in certain of their business units. And both Galvão Engenharia and OAS, which were also implicated in the *Lava Jato* investigation, have filed for bankruptcy.

In spite of the above, transactions have taken place in Brazil, as parties have been able to work around these risks through robust contractual provisions, including strong indemnity clauses and credit protection provisions, such as escrows and collateral.

In addition to contractual protections, Brazilian Federal Decree 8420 allows a leniency agreement to extend to companies within the same corporate family provided that those entities jointly execute the agreement. Therefore a target might receive protections through the leniency agreement of a member of its corporate family that would cabin its damages. For example, some recent agreements have allowed for the sale of assets free and clear of any liabilities.<sup>5</sup> As such, it is also important for an acquiring company to review any related leniency agreement to understand what protections might be afforded the target (and, conversely, what corresponding obligations the target might also be required to undertake).

Regardless of whether a leniency agreement is in place, other Brazilian authorities, such as the Comptroller's Office (*Controladoria-Geral da União* or CGU), the Attorney General of Brazil (*Advocacia-Geral da União* or AGU), of the Court of Accounts (*Tribunal de Conta da União* or TCU), may have ongoing proceedings related to the target or other entities within the same corporate structure. An acquiring company should understand the scope and risks of those proceedings since some of these authorities have continued to pursue actions against companies, even where a leniency agreement has been signed.

## Conclusion

The far-reaching investigations in Brazil as well as the country's strict approach to corruption have caused a domino effect of sorts, resulting in anticorruption investigations and prosecutions in other jurisdictions as well. The upside is that as a result of this shift in attitude towards corruption, many companies have begun internal investigations to ensure they have not engaged in corrupt behavior, and many more are implementing compliance programs to map out risks and avoid any such issues in the future.

In the meantime, while there is a lot of opportunity for acquiring companies and assets in Brazil, it is critical to understand those risks and to formulate a plan to minimize them. ■

1. Most recently, on November 29, 2017, the DOJ released a new FCPA Corporate Enforcement Policy in which it stated that there is a presumption that the DOJ will decline to prosecute companies that voluntarily disclose misconduct in an FCPA matter, fully cooperate and timely and appropriately remediate, so long as there are no aggravating circumstances and those companies pay all disgorgement resulting from the misconduct. Dep't of Justice, *United States Attorneys' Manual*, "FCPA Corporate Enforcement Policy," Section 9-47.120, <https://www.justice.gov/archives/opa/blog-entry/file/838386/download>. The new policy also sets forth reductions on fines available to eligible companies. See Cleary Gottlieb Alert Memorandum, "DOJ Releases FCPA Corporate Enforcement Policy" (Dec. 1, 2017), available at <https://www.clearygottlieb.com/news-and-insights/publicationlisting/doj-releases-fcpa-corporate-enforcement-policy-12-1-17>.
2. Criminal Div. of the U.S. Dep't of Justice & the Enft Div. of the U.S. Sec. and Exch. Comm'n, *FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act 29*, <https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf> (last visited Jul. 21, 2017). See also Dep't of Justice, *Foreign Corrupt Practice Act Review*, No. 08-02, Opinion Procedure Release (2008).
3. The inability to conduct enhanced due diligence does not necessarily mean a high-risk transaction should be avoided. In a 2008 release, the DOJ indicated that it would not take an enforcement action against a company unable to perform pre-closing diligence, provided the company disclosed any identified violations, remediated such violations within the 180-day period and completed its proposed due diligence and remediation by no later than one year from the date of closing. Dep't of Justice, *Foreign Corrupt Practice Act Review*, No. 08-02, Opinion Procedure Release (2008). More broadly, the 2008 release and other DOJ statements indicate that, particularly when the opportunity for pre-close diligence is limited, the DOJ will allow buyers to act promptly post-close to conduct diligence and institute remedial actions. The standards set by the 2008 release, however, would be quite difficult to meet.
4. The Clean Company Act does not explicitly provide for successor liability in the case of an asset sale.
5. Notably, on August 24, 2017, Brazilian federal prosecutors issued new guidance on the process for negotiating and memorializing leniency agreements. This guidance provides additional transparency about the process and requires, among other things, that the leniency agreement address the obligations of the company, as well as whether the company has authorization to sell its assets. Orientação No. 07/2017, 5ª Câmara de Coordenação e Revisão, *Acordos de Leniência* (Aug. 24, 2017) available at [http://www.mpf.mp.br/pgr/documentos/ORIENTAO7\\_2017.pdf](http://www.mpf.mp.br/pgr/documentos/ORIENTAO7_2017.pdf).



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enforcement and other matters throughout Latin America, including the *Petróleo Brasileiro S.A. – Petrobras* securities litigation, the independent investigation of *GOL Intelligent Airlines Inc.* stemming from FCPA allegations, as well as many other FCPA and compliance matters for companies in Brazil. She also has an active criminal pro bono practice. Lisa joined the firm in 2005 and became a partner in 2015.



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tion into FCPA allegations for *GOL Intelligent Airlines Inc.* Kate joined the firm in 2010.

## LEGISLATION WATCH / NETHERLANDS



# A New Tool for Dutch Restructurings: The Ability to Bind Holdouts without a Formal Insolvency Proceeding

By CHRISTIAAN ZIJDERVELD and CLARK WARREN

## Introduction

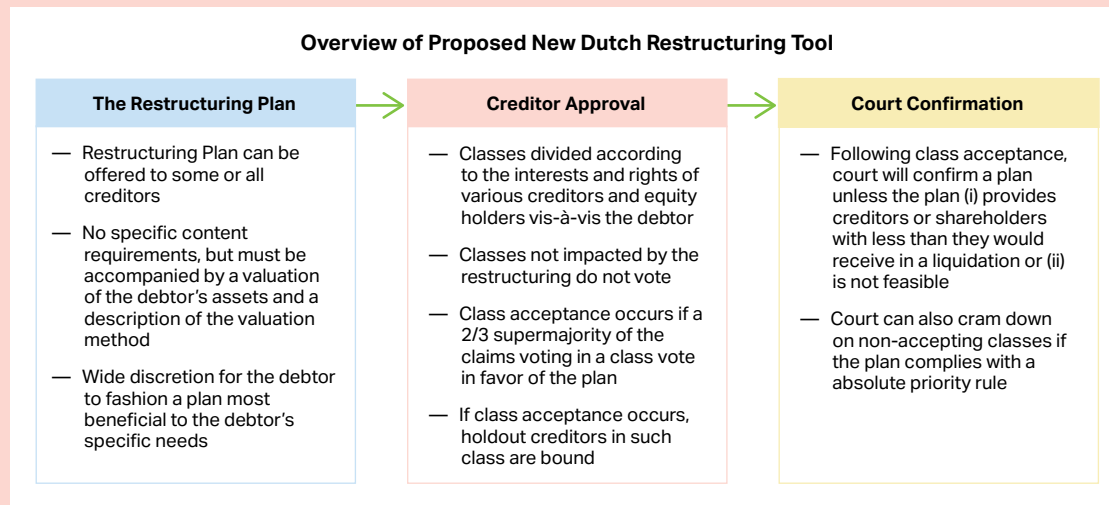
On September 5, 2017 the Dutch justice department published a draft bill which introduces a new debtor-in-possession restructuring tool. The draft bill allows a debtor to present a restructuring plan outside of formal bankruptcy proceedings, a process previously unavailable under Dutch insolvency law. Such a plan can (upon acceptance by a qualified majority of creditors and/or shareholders, as applicable) be confirmed by a court, thus making it binding upon creditors and shareholders. An earlier version of this bill was published in 2014, but was not ultimately passed into law.

Currently, Dutch law does not enable a debtor to implement a restructuring outside of formal insolvency proceedings, unless all creditors agree. Accordingly, holdout creditors generally cannot be forced to accept a restructuring, unless a

restructuring plan is presented within formal insolvency proceedings. The draft bill seeks to provide a framework for presenting a restructuring plan whereby the debtor remains in possession and no formal insolvency proceedings are opened, as well as enable the debtor to proceed with a restructuring where not all creditors are in agreement.

Should the draft bill enter into force, debtors will be able to offer a restructuring plan that can, if supported by the requisite majority of creditors and/or shareholders, be confirmed by a court, making it binding on all secured and unsecured creditors as well as shareholders, regardless of whether these parties voted for or against the plan or abstained from voting. By introducing a cram-down mechanism, the draft bill aims to minimize the need for viable enterprises to enter into formal bankruptcy proceedings. Parts of the draft bill were inspired by Chapter 11 of the U.S. Bankruptcy Code and the UK scheme of arrangement, each of which provides a

### Overview of Proposed New Dutch Restructuring Tool



“pre-packaged” procedure in which creditors agree on the terms of a restructuring outside of court and then such restructuring is brought to the court only after it has been approved by the requisite majorities.<sup>1</sup> This bill anticipates the coming into force of the draft directive of the European Commission on preventive restructuring frameworks as published on November 22, 2016.<sup>2</sup>

## Offering a Restructuring Plan

Under the draft bill, a debtor entity<sup>3</sup> can offer a restructuring plan to all or some of its creditors and shareholders. This means that a plan may target specific parts of the capital structure. One or more creditors can also take the initiative and ask a debtor to propose a plan. Should the debtor refuse, each creditor may petition the court to appoint an expert who can then offer a plan on the debtor’s behalf.<sup>4</sup>

Apart from certain formalities, e.g. the plan must be accompanied by a valuation of the debtor’s assets and a description of the valuation methods, the draft bill does not set any requirements for the plan’s contents as such. Instead, it grants the debtor substantial leeway in composing a plan. A plan can substantially amend the existing creditors’ and shareholders’ rights and, *inter alia*, result in the deferral or release of payment obligations, the amendment of the terms of debt instruments, or a debt for equity swap. A plan may also seek to restructure the claims of creditors with respect to guarantors, third-party security providers or co-debtors.

The draft bill also enables a debtor to amend the terms and conditions of long-term agreements,

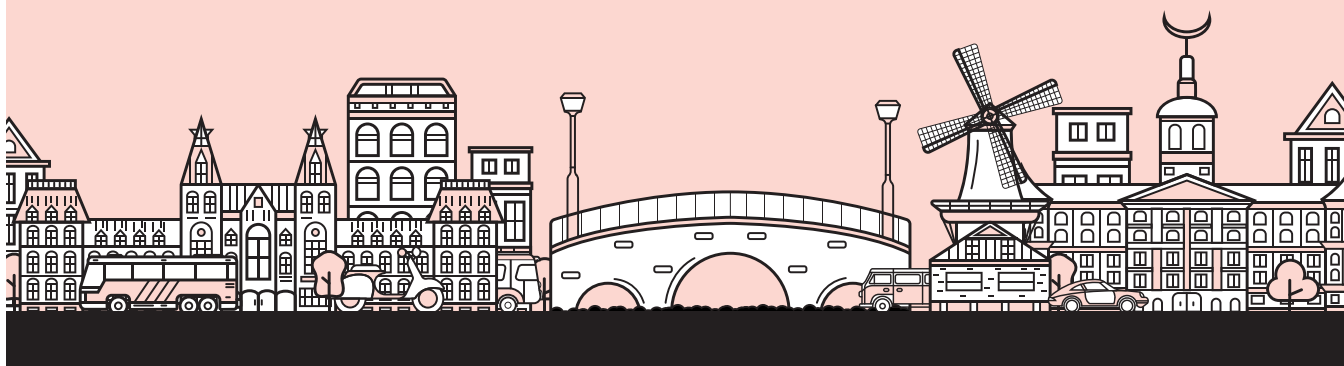
such as leasing contracts. The debtor may terminate the contract (subject to a maximum notice period of three months) when the counterparty refuses the debtor’s amendment proposal. In addition, any compensation to which the counterparty would be entitled as a result of the amendment or termination of the contract can be limited as part of the plan.<sup>5</sup>

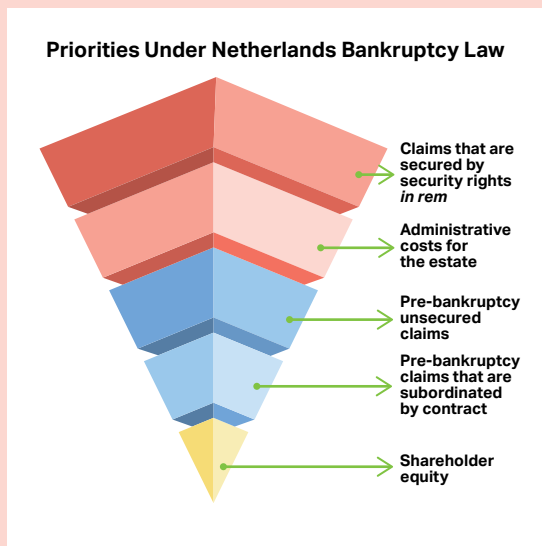
The offering of a plan and the corresponding negotiations will not automatically stay any enforcement actions by the creditors, including requests to open insolvency proceedings. At the debtor’s request, however, the court can freeze individual enforcement actions, including any petition for bankruptcy. A court-granted stay has a maximum duration of four months.

## Voting and Confirmation Process

A restructuring plan, before it can be confirmed by a court, needs to be accepted by at least one class of creditors and/or shareholders. A 2/3 supermajority of the claims voting in a class is required for acceptance. For the purposes of voting creditors and/or shareholders are subdivided into classes. Class composition is determined by looking at the interests and rights that certain groups of creditors and shareholders have in common. Creditors and shareholders that do not share the same bankruptcy priority<sup>6</sup> will always compose a separate class.<sup>7</sup>

Although a plan may effectuate a comprehensive debt restructuring across all classes, it may also be limited to a particular class. Subsequent voting is restricted to creditors and shareholders who are affected by the plan. Before the plan is submitted to a vote, interested parties can, if so inclined petition





the court to rule on various issues, such as alleged inadequacy of the information provided by the debtor, admission of certain creditors or shareholders to voting, class constitution, voting procedures, etc. Any court decision is final and not subject to appeal.<sup>8</sup> Once the court has ruled, or no petition has been filed, the plan will be submitted to a vote to all the creditors and/shareholders that would be affected by the plan.

Once at least one class accepts the plan with a 2/3 supermajority, the plan can be submitted to the court for confirmation. The court will refuse to confirm a plan under which creditors or shareholders would receive less than they would in formal bankruptcy proceedings (the “best interest of creditors test”), or if there is insufficient evidence that the plan is feasible.<sup>9</sup> The court can also set aside the non-acceptance of one or more classes and confirm the plan, but only if the plan’s contents are in accordance with an absolute priority rule that is intended to be modeled on the absolute priority rule as enshrined in Chapter 11 of the U.S. bankruptcy Code. The current phrasing intends to clarify that a court should not confirm a plan if (1) a crammed down creditor, that voted against the plan is impaired and (2) the plan ‘elevates’ a lower ranking creditor/shareholder.

Once the court confirms the plan, it will bind all classes and their members including the creditors and shareholders who voted against the plan or abstained from voting. As a result, all their rights against the debtor will be amended in accordance with the plan. The draft bill also provides a mechanism for ensuring implementation even if the plan is not supported by shareholders: the court’s order confirming the plan can replace a shareholders resolution which may be needed to implement it (this could be needed if, for example, during a shareholders meeting one or more shareholders refuse to vote in favor of implementing the plan).

## Other Measures Envisioned by the Draft Bill

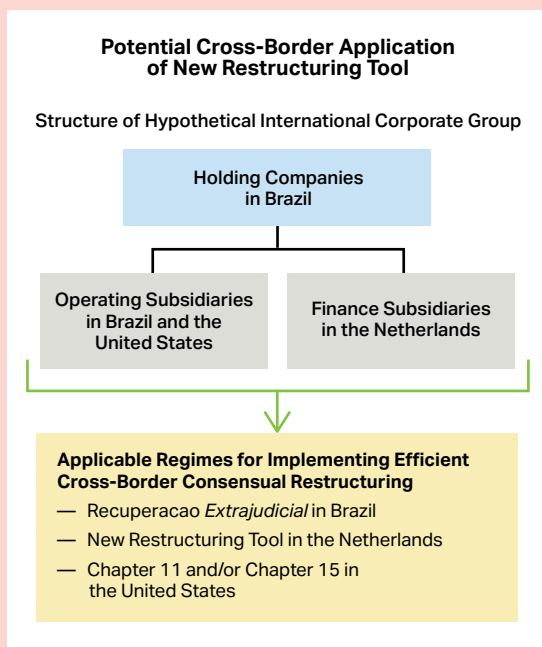
In addition to its powers to confirm or reject a composition plan, the court has general authority to order all measures it deems necessary to adequately protect the interests of the creditors and shareholders. This provision is similar to 11 U.S.C. § 105, under which U.S. bankruptcy courts can “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title”.

The draft bill also contains ‘safe harbor’ rules for security interests conveyed in exchange for ‘fresh’ funds that seek to facilitate the realization of the restructuring plan. In case the restructuring plan fails and the debtor enters into formal insolvency proceedings, these rules should protect the creation of the aforementioned security interest from being avoided by a bankruptcy trustee, should the debtor enter into formal insolvency proceedings after all.

## Conclusion

For distressed companies, the revised bill will provide a quick and effective way to restructure debts without the possibility of being blocked by a minority of opposing creditors or shareholders. Perhaps even more importantly for debtors, the process does not involve an administrator or bankruptcy trustee, thus allowing the debtor to remain in possession.

From an emerging markets perspective, the new legislation is particularly relevant because it could simplify the process for implementing complex cross-border consensual restructurings, particularly when paired with prepackaged options in other jurisdictions. For example, a Brazilian corporate group with finance subsidiaries in the Netherlands could concurrently make use of Brazil's *recuperação extrajudicial* process and the new legislation in the Netherlands (together with other proceedings as necessary, such as Chapter 11 or Chapter 15 in the United States) to implement a relatively quick consensual restructuring with minimal court involvement.



The comment period, during which interested parties could submit their views on the draft bill to the Dutch justice department, closed on December 1, 2017. The draft bill has been received favorably by the market and expectations are that a final draft could be submitted to Dutch parliament somewhere in the first six months of 2018. Barring any delays during the parliamentary process, the bill could be enacted by early 2019.

1. For the avoidance of doubt, however, there are significant differences between Chapter 11 and the UK scheme of arrangement, including with respect to pre-filing conduct, debtor

eligibility, the scope of any applicable stay, the role of the court, the composition of classes, voting thresholds, the ability to bind holdouts in the same class and the ability to cram-down on non-consenting classes.

2. 2016/359 (COD), COM (2016) 723 final.
3. The explanatory memorandum to the draft bill notes that multiple related debtors' plans may, from an administrative perspective, be dealt with concurrently by the court.
4. The draft bill does not provide much guidance, but we expect that the court appointed expert will prepare and offer a plan in the same manner as the debtor would otherwise do.
5. Presumably, in most cases the nominal amount for compensation because of termination will be treated as a pre-bankruptcy unsecured claim, meaning that it may be subjected to the discount that the plan provides for.
6. Generally speaking – and subject to many exceptions – Dutch law allows for the following list of priorities: (1) claims that are secured by security rights *in rem*; (2) administrative costs for the estate (3) pre-bankruptcy claims that have preference as determined by law; (3) pre-bankruptcy unsecured claims; (4) pre-bankruptcy claims that are subordinated by contract; and (5) shareholder equity.
7. The draft bill gives limited guidance as to class composition. Creditors and other interested parties can turn to court to challenge the composition of classes. Presumably in due course case law will provide further guidance.
8. Court involvement is optional. If the plan can be completed consensually there is no need to involve the court.
9. As noted above, the draft bill stipulates that a proposed plan should be accompanied by a valuation report.



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# Assessing a New Evolution in Chile: In-Court Reorganization Proceedings

By FRANCISCO JAVIER ILLANES and SERGIO BALHARRY



Chile enacted a new insolvency law (*Ley de Reorganización y Liquidación de Activos de Empresas y Personas*, or the “New Insolvency Law”) that went into effect in October 2014. Several novelties were introduced, including the introduction of special insolvency proceedings for individuals, the inclusion of the UNCITRAL Model Law on cross-border insolvency, and a new Agency of Insolvency and Re commencement. The New Insolvency Law also purports to correct the long duration of insolvency proceedings under the previous law.<sup>1</sup> However, the most important development is a new in-court reorganization proceeding (*procedimiento concursal de reorganización*), which is somewhat comparable to a Chapter 11 proceeding of the U.S. Bankruptcy Code.

## Scenario before the New Insolvency Law

The previous insolvency law included the possibility of avoiding bankruptcy through a “Preventive Judicial Agreement” (*Convenio Judicial Preventivo*). By means of an in-court proceeding, the debtor would be able to obtain an agreement that would be binding on its creditors. This procedure had several shortcomings for the debtor. Possibly the most relevant of these deficiencies were:

- a. **The agreement was only binding on unsecured creditors.** Secured creditors could only participate and vote in the relevant creditors meeting, and become a party to the agreement, if they waived their preferred ranking status. In practice, secured creditors normally preferred to keep their preferred ranking status to be able to enforce their collateral, so it was not common that the Preventive Judicial Agreement was binding on this class of creditors. This meant that in spite of Preventive Judicial Agreements, secured creditors could enforce their collateral. But, if the assets granted as collateral were deemed to be essential for the debtor’s normal operation, the enforcement of the collateral would make it very difficult for the debtor to continue with its operations and comply with its obligations under the Preventive Judicial Agreement.
- b. **Collection and enforcement proceedings against the debtor continued.** During the proceeding to obtain a Preventive Judicial Agreement, creditors could still initiate collection proceedings against the debtor or enforce collateral granted to secure their credits. The collection and enforcement proceedings were only suspended if the debtor had presented the agreement proposal with the support of two or more creditors representing more than 50% of the total debts. Therefore, prior to the initiation of the proceeding to obtain a Preventive Judicial Agreement, the debtor would need to negotiate to obtain creditors’ support, but without any protection against possible legal actions during that period. This resulted in an important risk that the debtor’s assets and operations would be adversely affected during the negotiation with its creditors.

## The New Reorganization Proceeding

One of the main innovations of the New Insolvency Law is a new in-court reorganization proceeding,<sup>2</sup> focused on allowing viable businesses to overcome temporary periods of financial distress. When the bill to modify the previous bankruptcy law was presented in May 2012, the President indicated that the project “is based on promoting and encouraging, in the first place, the effective reorganization of viable enterprises, that

is, to allow that an enterprise that has the possibility to subsist and flourish may overcome the transitory difficulties in which it is, with help from its creditors and in pursuit of continuing as a productive unit.”

### Of Bankruptcy, Insolvency and Criminal Offenses

The objective of the New Insolvency Law to promote the continuation of viable businesses is not only embodied by the inclusion of the new in-court reorganization proceeding, but it also becomes apparent through several other legal provisions.

For example, the New Insolvency Law abolishes the term “bankruptcy”, replacing it with the terms “insolvency”, “reorganization” or “liquidation”, depending on the case. The idea behind this change was that the term “bankruptcy” was perceived too negatively. The view was that a debtor involved in a bankruptcy carried a sort of “social stigma”, which reduced the possibilities of reinserting that debtor as a productive business unit. The new wording would be perceived as more “technical” and less “disgraceful”, thus making it easier for debtors to make use of the insolvency proceedings provided under the New Insolvency Law to effectively reintroduce themselves in the economy.

Another example is the modification of the rules about insolvency criminal offenses. Under the previous insolvency law, a debtor was subject to criminal penalties if its bankruptcy was considered guilty or fraudulent. The law did not include a definition of “guilty” or “fraudulent” bankruptcy. Rather, it described several conducts that were legal presumptions of a guilty or fraudulent bankruptcy. This legal technique considered by some as confusing and outdated, so the New Insolvency Law replaced it with a description of specific conducts that constitute crimes in the context of an insolvency, but without considering the insolvency itself as a crime. Also, under the previous law, a debtor that failed to request its own bankruptcy within a short term from the date of suspension of payments could be exposed to criminal liability. This sanction was eliminated under the New Insolvency Law.

The new reorganization proceeding deals with the main shortcomings of the Preventive Judicial Agreement:

- a. For example, the New Insolvency Law does not require that a secured creditor waive its preferred ranking status to become subject to the reorganization agreement. A debtor may now submit a reorganization plan that includes

provisions binding on unsecured creditors as well as secured creditors. If the reorganization plan proposed by the debtor is approved by its creditors, with certain voting thresholds that need to be met by each class of creditors, the reorganization agreement becomes binding for both secured and unsecured creditors. This allows the debtor to effectively continue its operations, as secured creditors would not be able to enforce their collateral and should only request payment in accordance with the terms of the reorganization agreement. Secured creditors, however, tend to have a negative view of this aspect of the law, as the effectiveness of their collateral is reduced in comparison to the previous law.

However, the reorganization agreement is not necessarily binding for all secured creditors. Creditors with collateral over assets that are not essential for the operation of the debtor's business are not affected by the reorganization agreement, and their credits are not considered for purposes of calculating the quorums required for the approval of the reorganization plan. This allows those creditors to enforce their collateral regardless of the terms of the reorganization agreement. As the objective of the reorganization proceeding is to allow a debtor to continue its operations, the law did not limit the possibility of creditors to obtain liquidity through the sale of assets that are not necessary for the continuation of debtor's business. The problem with this approach is the difficulty to determine if an asset granted as collateral is essential or not. The New Insolvency Law initially grants the debtor the opportunity to determine which of its assets are essential for its business, at the time of filing for the reorganization proceeding. Afterwards, creditors have a period of time to contest the "essential" condition of an asset, in which case it will ultimately fall on the court to decide on whether the relevant asset is essential or not for continuing the debtor's business.



#### Creditors Related to the Debtor

It is possible, and to a certain point quite common, for debtors to have related party creditors. The New Insolvency Law provides special rules applicable to those credits, starting with a list of persons that are considered "Related Persons" to the debtor, such as:

- certain relatives of the debtor or of its representatives;
- parent or subsidiary companies of the debtor;
- directors, managers, administrators, principal executives or liquidators of the debtor, and certain relatives of those persons, as well as any entity controlled, directly or through others, by any of them; and
- persons who, on their own or with others with whom they have joint action agreements, may designate at least one member of the management of the company or control 10% or more of the equity or voting capital.

Creditors who are considered related persons do not have the right to vote in reorganization proceedings, and their credits are not considered for purposes of calculating the quorums required for the approval of the reorganization plan.

However, their credits are treated as any other credit for purposes of the reorganization agreement, and those creditors would be paid in accordance with the terms and conditions of the agreement. Yet, in certain cases the credits of related persons are subordinated to the payment of the credits of unsecured creditors, such as when the credit of a related party is not properly documented at least 90 business days prior to the initiation of the reorganization proceeding.

- b. The debtor that requests the initiation of a reorganization proceeding benefits from a stay period, which is triggered by a court resolution promptly after the filing once the debtor has submitted additional documents, without needing creditors' prior support. This stay period is called "*Protección Financiera Concursal*". During this stay period, no execution or enforcement procedures may be initiated against the borrower. If these legal procedures had commenced before the stay period, they will be suspended. Also, the event of the initiation of the reorganization proceeding cannot be claimed as grounds for: (i) the unilateral termination of agreements entered into by the debtor; (ii) the acceleration of debts; and (iii) the enforcement of collateral granted by the debtor. The debtor continues to manage its business during this stay period, but the debtor is subject

### Stay Period

The stay period lasts, initially, 30 business days. However, there are several cases in which this period may be extended with creditors' support:

1. With the support of two or more creditors representing more than 30% of the total debts, excluding credits from related parties, the stay period may be extended for up to 30 additional business days.
2. With the support of two or more creditors representing more than 50% of the total debts, excluding credits from related parties, the stay period may be extended for up to 60 additional business days, or for 30 additional business days if the stay period was extended according to number 1) above.
3. At the end of the stay period, a creditors' meeting will determine if the reorganization plan is approved or not. If the reorganization plan is not approved, a liquidation proceeding against the debtor would normally be initiated. However, the creditors may agree on giving the debtor a chance to present a second reorganization plan, in which case the stay period is extended for 20 business days. The quorum required in this case is two-thirds of the total debts with right to vote.

4. The creditors' meeting that needs to decide on the reorganization plan may also agree on suspending the meeting to decide on the reorganization plan at a later date. The suspension may last for up to 10 business days, during which the debtor still benefits from the stay period. This suspension needs to be approved by the absolute majority of the total debts with right to vote.

Local lawyers have also been able to extend the stay period without the need of obtaining the support of creditors, at least on a limited basis. They do so by applying general provisions of the civil procedure rules, specifically the possibility of requesting a prejudicial injunction (*medidas prejudiciales precautorias*) from the courts. Through the prejudicial injunction proceeding, the debtor informs the court that it will initiate a reorganization proceeding, to obtain a court resolution prohibiting specific creditors from unilaterally terminating agreements that are essential for the debtor's business. This protection lasts for a limited time (between 10 and 30 business days), and is only effective against creditors that are a party to the prejudicial injunction proceeding. However, this mechanism has helped debtors to obtain extra days to be able to prepare the documents required to request the initiation of a reorganization proceeding, to prepare a better reorganization plan and to try to obtain the support of creditors for the plan.

to certain limitations, and an overseer (*veedor*) is appointed by the court to oversee the reorganization process, with supervision authorities over the management of the debtor.

## Reorganization Proceedings in Practice

It is still early to determine whether the New Insolvency Law will be successful in allowing viable enterprises to overcome periods of financial distress. However, a timely question might be whether debtors are using this new mechanism.

According to data provided by the Agency of Insolvency and Re commencement (*Superintendencia de Insolvencia y Reemprendimiento*, or the "Agency"), 53 reorganization proceedings were initiated during 2016. During the same period, 701 liquidation proceedings were initiated. Although debtors may be more inclined to use reorganization proceedings in the future, from these numbers it is apparent that reorganization proceedings are, for now, still far from replacing liquidation proceedings.<sup>3</sup> One possible explanation for this relatively low number is that a majority of the enterprises that initiated insolvency proceedings simply were not economically viable

entities: debtors in financial distress may have undergone liquidation proceedings if they considered that a reorganization proceeding was not a feasible option. Another reason may be that debtors prefer to reach private agreements with their financial creditors without using the reorganization proceeding, and therefore those private agreements would not be reflected in the data of the Agency. This is usually the preferred first choice for larger debtors.

Under the prior insolvency law, it was common practice that debtors, whose creditors were mainly banks, did not file for a Preventive Judicial Agreement, but instead negotiated with their financial creditors a private agreement restructuring its debt. This normally involved term extensions and granting of collateral, rather than debt haircuts. In these cases, the financial creditors generally acted as a group to negotiate with the debtor and reach an agreement. It is possible that both creditors and debtors are still accustomed to this practice and use it instead of a reorganization proceeding, which may be perceived as a last resort because a liquidation proceeding would normally be initiated if the reorganization plan is not approved. Also, it seems that local banks consider that

#### The Agency's View on the Use of Reorganization Proceedings<sup>4</sup>

The New Insolvency Law is an important regulatory development with respect to the prior insolvency law. First, it distinguishes between different types of debtors, by creating proceedings designed specifically for legal entities and those for individuals. Regarding the proceedings applicable to legal entities, and following international best practices, the New Insolvency Law seeks to distinguish between proceedings for debtors with an economically viable business and those in an unsustainable business. For the first group of debtors, it provides a flexible and transparent reorganization proceeding, and for the second group, a fast and efficient proceeding to liquidate assets. The New Insolvency Law also introduces the proper incentives in each proceeding, so that creditors and debtors may decide between one and the other by using as sole criteria the real possibility of obtaining the recovery of the business.

In this regard, the Agency communications campaign about the New Insolvency Law resulted in widespread promotion of insolvency proceedings as a possible solution to the over

indebtedness of Chileans. Under the prior insolvency law, there were an average of 143 bankruptcy proceedings and 11 restructurings per year, while under the New Insolvency Law, there have been an average of 512 liquidation proceedings and 49 reorganization proceedings per year between 2015 and 2016.

Reorganization proceedings take an average of 84 business days from the date of filing to the date of the creditor's meeting that needs to decide on the reorganization plan, which is less than the originally expected term of four months. In addition, 51% of the debtors are large-size companies, while 26% are medium-size companies, 10% small companies and 13% micro-enterprises. With respect to the business activity of these debtors, 22% conducted commercial activities, followed by construction with 21% and non-metallic industries with 15%.

Based on the data mentioned above, it seems that this tool is used mostly by large companies, unlike liquidations proceedings that normally apply to medium and small companies and

micro-enterprises. As a comparison, until July 2016, the total debt recognized in liquidation proceedings was an average of USD 237,000,<sup>5</sup> while in reorganization proceedings the average was of approximately USD 23.7 million.<sup>6</sup>

According to data provided by the Chilean tax authority, in 2015, 96% of Chilean companies were either small companies or micro-enterprises. Thus, the fact that the majority of the debtors filing for reorganization proceedings are large companies is caused, to a greater or lesser extent, by several entry barriers provided by the law, which are the costs and formalities related to the initiation of the reorganization proceeding. According to studies by the Agency, the average fee of the overseers (*veedores*) is approximately USD 16,720. This cost is increased by the fees of the debtor's counsel and of the independent auditor that must issue a certificate of the debtor's situation under the proceeding. Only considering the costs involved, the proceeding becomes a barrier that is difficult to overcome for smaller companies in financial distress.

reorganization proceedings represent an improvement of the debtor's negotiating position. Therefore, these creditors may still prefer to avoid that their debtors initiate reorganization proceedings. This may vary on a case-by-case basis, as creditors may also be interested in restructuring the debtor's debt through a reorganization agreement, for example, to avoid the possibility of claw-back actions that could affect a private restructuring agreement.

Also, in certain cases, in-court reorganization proceedings have not been used as originally intended. Local legal practice has sometimes used these proceedings as an alternative way to liquidate the debtor's assets to pay its creditors, instead of using it as a way to allow the debtor to continue its operations. In these cases, creditors try to achieve the liquidation of the assets of the debtor in an organized manner. The debtor and its

creditors would still be required to agree on a reorganization agreement, but the contents of the agreement would refer to the way the debtor should operate its business and liquidate its assets. Unlike a "regular" liquidation proceeding, in which the debtor's business is managed by a court-appointed trustee, and unlike a "regular" reorganization proceeding, in which essential assets are not liquidated to allow the continuation of the debtor's business, in this "liquidation reorganization agreement" the debtor continues to manage the company, but only to liquidate all of its assets in the manner agreed with its creditors.

### Claw-back Actions

The New Insolvency Law amends the former claw-back period rules such that, generally, any transfer, encumbrance or other transaction executed or granted by the debtor during the term of two years prior to the commencement of the reorganization or liquidation proceedings, may be rendered ineffective if it is proved before the court that such transfer, encumbrance or transaction: (i) was entered into with the counterparty's knowledge of the debtor's poor business condition; and (ii) caused damages to the bankruptcy estate (e.g., that the transaction has not been entered into under terms and conditions similar to those prevalent in the market at the time of its execution) or has affected the parity that shall exist among creditors.

Similarly to the previous insolvency law, the New Insolvency Law also provides certain cases in which transfers, encumbrances or other transactions executed or granted during the term of one year prior to the commencement of the insolvency proceedings (extendable to two years in certain events) are deemed ineffective, based on objective grounds, such as pre-payments, payments with terms different than as originally agreed to by the parties and creating security interests to guarantee pre-existing obligations.

### Some Underused Mechanisms of Reorganization Proceedings

The New Insolvency Law includes several mechanisms related to reorganization proceedings, which have not yet received much practical application, such as:

1. Out-of-court reorganization proceedings (which are somewhat comparable to a pre-packaged bankruptcy under U.S. Chapter 11).
2. Insolvency arbitration.
3. Cross-border insolvency proceedings.

## Positive Experiences

There are several successful experiences with reorganization proceedings, some of which include important local companies. Examples of companies that have successfully undergone reorganization proceedings include *Transportes Tamarugal Limitada* (“Tamarugal”) and *Caja de Compensación de Asignación Familiar La Araucana* (“La Araucana”):

- a. **Tamarugal** is one of the major players in the mining transportation industry, with more than 40 years of business experience. Because its main focus was providing services to mining companies, a drop in the price of mining commodities and the subsequent suspension or cancellation of mining projects had a serious impact on Tamarugal's business. In 2014, it reported losses for approximately USD 16 million, and a debt-to-equity ratio of 17.5. By the time it requested the initiation of a reorganization proceeding, its total debt was approximately USD 120 million, involving approximately 500 creditors which included banks, factorizing companies and suppliers.

As the amount of the total debt was relevant, and the number of creditors high, it was not easy to reach an agreement. And it was not possible to agree on the reorganization plan within the standard 30 business day stay period. The stay period was extended two times (each time for additional 30 business days) before the reorganization plan was approved by the creditors. Overall, the proceeding lasted for about six months until the reorganization agreement entered into effect.

Approximately one year after the approval of the initial reorganization agreement, Tamarugal asked its creditors for a modification of the terms of the agreement. Some reasons to request this modification included that several projections discussed with its creditors to approve the initial reorganization agreement could not be met, and that the covenants assumed by the debtor limited its ability to renew its vehicle fleet. The modification of the reorganization agreement proposed by debtor, including a new business plan, was successfully approved by its creditors.

- b. **La Araucana** is a major non-profit private entity that manages social security benefits for its members and their families. This type of legal entity is subject to special legal rules and regulations. Prior to the initiation of the reorganization proceeding, La Araucana became subject to an “intervention”, mainly because of its failure to fulfill certain requirements made by the Chilean Social Security Agency (*Superintendencia de Seguridad Social*). Therefore, management was replaced by an independent controller appointed

by the Chilean Social Security Agency. The independent controller decided to initiate a reorganization proceeding, as La Araucana was unable to fulfill its obligations in due time. At the time of the initiation of the reorganization proceeding, its total debt exceeded USD 600 million, with creditors that included banks and holders of notes issued under Chilean law.

Similar to the Tamarugal case, it was not possible to reach an agreement quickly. The stay period was extended one time, for an additional 60 business days period, before the reorganization plan was approved by the creditors. Overall, the proceeding lasted approximately four months until the reorganization agreement entered into effect. La Araucana recently obtained the approval of its creditors for a modification of the reorganization agreement, which, in summary, allowed it to extend the payment terms of its debt.

In both cases, because of the short amount of time passed since the approval of the reorganization agreement and its modifications, it may be too soon to know if Tamarugal and La Araucana will be able to pay their restructured debt. But from a legal perspective, the New Insolvency Law provided adequate mechanisms to allow debtors to negotiate with their creditors under a judicial proceeding that gave them much needed “breathing space” in the form of a stay period. Both cases show that, despite the relatively low use of the reorganization proceeding so far, the New Insolvency Law has the potential to be an effective tool to help debtors and creditors reach an agreement that is acceptable for the creditors and feasible for the debtor. The fact that Chile improved from position 110 to position 55 in the ranking on the ease of resolving insolvency according to the data collected the World Bank (Doing Business 2012 and 2017 reports), also shows that the changes introduced by the New Insolvency Law are in the right direction. ■

### The Agency's View on Successful Reorganization Proceedings.<sup>7</sup>

Based on the experience gained from the first years of the New Insolvency Law, it is possible to confirm that the debtors that have a higher possibility of undergoing a successful restructuring are those that meet certain characteristics. First, they need to have their accounting books up to date, as this would allow making cash flow projections to determine the future payment capacity of debtors. This analysis allows debtors to determine if positive cash flows, with real profit, are possible; if strategies to reduce operational expenses are required; if certain economic activities that do not generate profits should be closed; along with other measures that may allow the repayment of the restructured debt.

Second, it is important for the debtor to have a good management team and an internal structure consistent with its financial and economic situation, or that such management team and structure are established in the reorganization agreement, including payment control policies and internal auditing to make the restructuring viable. These types of measures give support to the performance of the payment calendar proposed by the debtor.

Finally, the possibility of a successful restructuring is also related to debtor compliance with labor obligations as of the date of filing. If a company has a high level of unpaid labor obligations, it is exposed to labor claims that may disproportionally increase its total debts and that may, in the end, hinder the fulfillment of the restructured debt.

1. According to data collected by the World Bank Group's Doing Business 2012 report, resolving insolvency in Chile took an average of 4.5 years, in comparison with 1.5 years in the United States and 1.3 years in Colombia.
2. The reorganization proceeding is applicable mainly to legal entities, but the New Insolvency Law also includes a special “renegotiation proceeding”, that is applicable exclusively to individuals.
3. However, the renegotiation proceeding applicable to individuals has been relatively more successful than the reorganization proceeding. During 2016, a total of 944 renegotiation proceedings have been filed, against a total of 1.175 liquidation proceedings against individuals.
4. This excerpt has been provided to the authors exclusively by the Agency of Insolvency and Recommencement for purposes of this article.
5. Average amount based on a sample of liquidation proceedings completed through June 2017.
6. Average amount based on a sample of reorganization proceedings completed through June 2017.
7. This excerpt has been provided to the authors exclusively by the Agency of Insolvency and Recommencement for purposes of this article.

## Scorecard of Chile's Insolvency Regime

**Experience Level:** Limited established precedents of successful in-court restructurings or significant cultural resistance to resolution of insolvency through court proceedings

### KEY PROCEDURAL ISSUES

Can bondholders/lenders participate directly (i.e., do they have standing to individually participate in a proceeding or must they act through a trustee/agent as recognized creditor?)	Yes
Involuntary reorganization proceeding that can be initiated by creditors?	No
Can creditors propose a plan?	No
Can a creditor-proposed plan be approved without consent of shareholders?	No
Absolute priority rule?	Yes
Are ex parte proceedings (where only one party participates and the other party is not given prior notice or an opportunity to be heard) permitted?	No
Are corruption/improper influence issues a common occurrence?	No
Viable prepackaged proceeding available that can be completed in 3-6 months	Yes
Secured creditors subject to stay period?	Yes
Creditors have ability to challenge fraudulent or suspect transactions (and there is precedent for doing so)	Yes
Bond required to be posted in case of involuntary filing or challenge to fraudulent/suspect transactions?	No
Labor claims can be addressed through a restructuring proceeding	No
Grants super-priority status to DIP Financing?	Yes, though limitations apply
Restructuring plan may be implemented while appeals are pending?	Yes
Does the restructuring plan, once approved, bind non-consenting (or abstaining) creditors?	Yes, with exceptions
Does the debtor have the ability to choose which court in which to file the insolvency proceeding (or is it bound to file where its corporate domicile is)?	No
Other significant exclusions from the stay period?	Yes
Prevents voting by intercompany debt?	Yes
Strict time limits on completing procedure?	Yes
Management remains in place during proceeding?	Yes (for reorganization proceedings) No (for liquidation proceedings)



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## DEAL NEWS / UAE



# Can the Sukuk Industry Survive the Dana Gas Dispute?

By DAVID J. BILLINGTON and MOHAMED TAHA

## Introduction

Islamic Sharia-compliant bonds, commonly referred to as sukuk (an Arabic term that literally means “instruments”), have been increasingly used in the past few decades in corporate as well as project finance transactions. As sukuk have become increasingly appealing to issuers and investors alike as risk-sharing debt instruments, sukuk issuance grew from U.S.\$20.6 billion in 2008 to a peak of U.S.\$131.2 billion in 2012, before declining to U.S.\$74.8 billion in 2016, when countries predominantly active in sukuk issuances were negatively affected by lower oil prices.

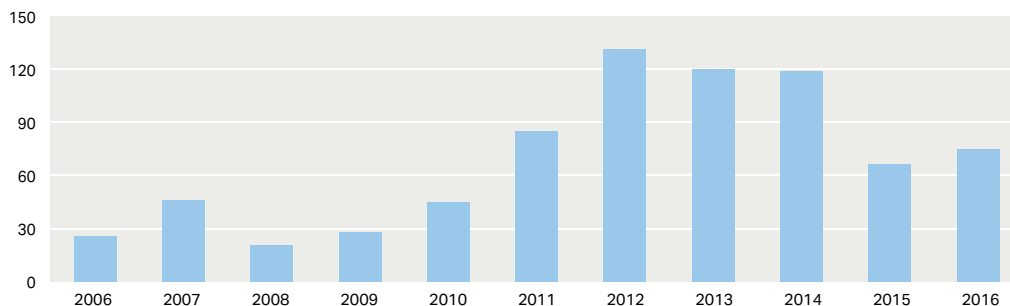
In competing with conventional bonds for investors’ liquidity, sukuk offers an investment solution that complies with the requirements of the Islamic faith, and a debt instrument that has, since the global financial crisis, been perceived as less risky than conventional bonds given its asset-backed nature. However, sukuk issuances are still significantly lower in number and volume than conventional bonds, even in countries with predominantly

Muslim populations. Part of the explanation for this discrepancy is the fact that, despite various trade bodies’ attempts, neither the structure nor documentation for sukuk issuances have become standardized. That lack of standardization has led to some uncertainty and skepticism around the rules governing sukuk, which has been exacerbated recently by a very public dispute between Dana Gas and the holders of its sukuk, that could jeopardize the entire market.

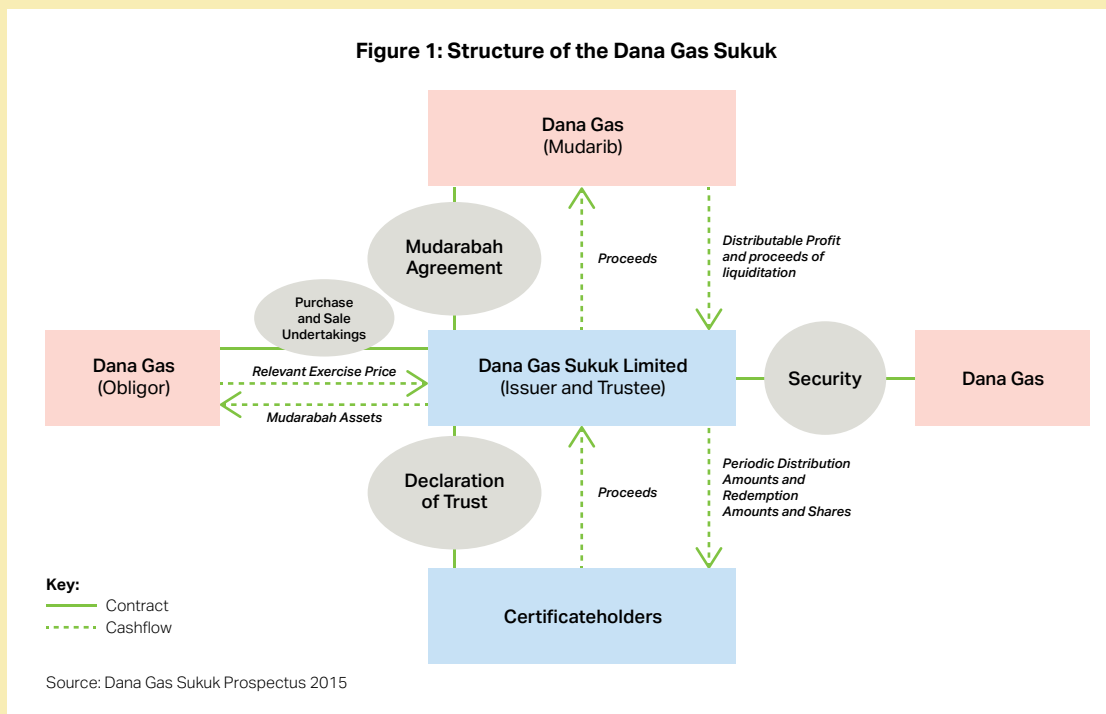
## The Dana Gas Sukuk Dispute

In 2013, Dana Gas issued a dual-tranche sukuk with an aggregate principal amount of approximately U.S.\$950 million listed on the Irish Stock Exchange. Each tranche of the sukuk was subsequently reduced to U.S.\$350 million following sukuk buyback and conversion, bringing the outstanding total principal amount under the sukuk to \$700 million due in October 2017. The sukuk were structured as sukuk al-Mudarabah. This type of sukuk involves the establishment of an orphan SPV in an offshore jurisdiction (in Dana Gas’s case, Jersey).

Global Sukuk Issuance  
USD bln



Source: Thomson Reuters, MIFC estimates



That SPV issues trust certificates to the investors, and uses the proceeds to enter into an investment arrangement (the “**Mudarabah Agreement**”) with the underlying obligor pursuant to which the SPV will acquire rights to specified business assets. The investors are entitled to share the returns generated by that investment arrangement – so instead of being structured as a debt obligation, this form of sukuk involves the beneficial entitlement to the financial returns generated by a pool of assets via a trust.

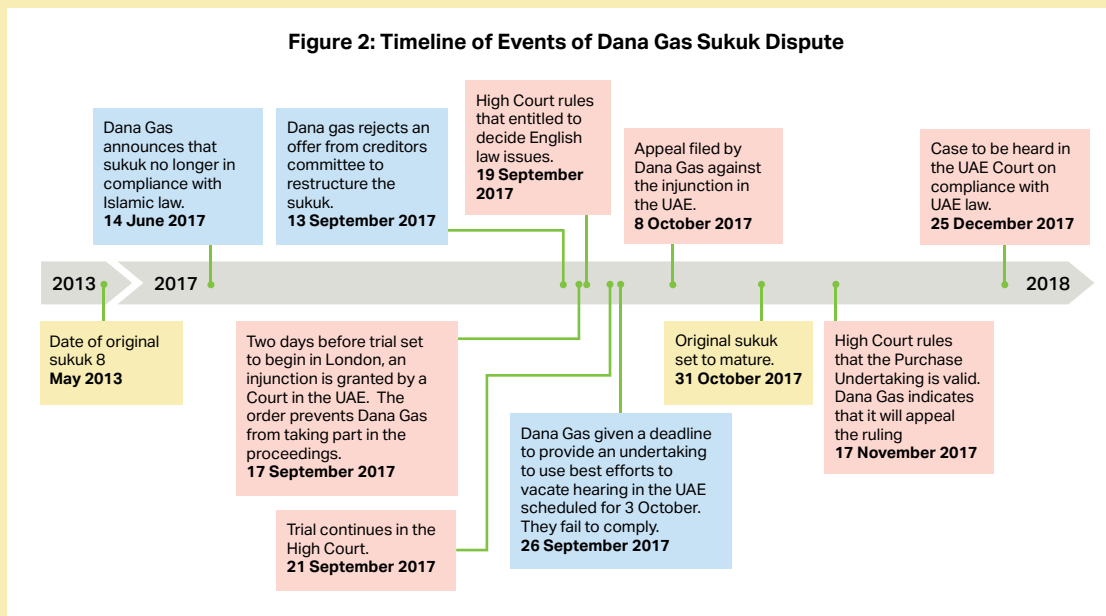
The investors are paid regular profit distributions, and the entire structure will be unwound at maturity (or earlier if certain events occur). At redemption, the underlying obligor is required to repurchase the issuer’s rights to the specified business assets, by paying a pre-determined exercise price (the “**Exercise Price**”).

Due to the commercial difficulties that Dana Gas has faced in the last few years, in 2017 it had commenced discussions with its investors with a view to agreeing on a restructuring. Those discussions did not progress very far, and in June this year, Dana Gas declared its outstanding sukuk void for their

non-compliance with Islamic Sharia law, citing “the evolution and continual development of Islamic financial instruments and their interpretation”.<sup>1</sup> Having declared its outstanding sukuk void, Dana Gas proposed to exchange the outstanding sukuk with new four-year Sharia-compliant sukuk that “confer rights to profit distributions at less than half of the current profit rates and without a conversion feature”,<sup>2</sup> an offer which was understandably declined by the certificateholders. In September this year, a creditor’s committee supported by 70% of the certificateholders offered Dana Gas a restructuring proposal involving a U.S.\$300 million cash payment and a three-year extension of the outstanding sukuk’s life. The proposal was rejected by Dana Gas, leaving the dispute to be resolved by courts.

In an attempt to pre-empt a declaration of an event of default or enforcement action by the certificateholders, Dana Gas brought an action in the High Court in London requesting that the English law governed purchase undertaking between Dana Gas and the SPV (the “**Purchase Undertaking**”) be declared void and unenforceable. Simultaneously, Dana Gas brought an action in the United Arab

Figure 2: Timeline of Events of Dana Gas Sukuk Dispute



Emirates (the “**UAE**”) seeking to challenge the validity of the UAE law governed Mudarabah documents for their non-compliance with Sharia law. In challenging the validity of the Purchase Undertaking before English courts, Dana Gas pleaded that (a) its obligation to pay the Exercise Price under the Purchase Undertaking is, upon proper interpretation of the Purchase Undertaking, conditional on the SPV’s ability to transfer its rights to the Mudarabah assets to Dana Gas under a UAE law governed sale agreement, which Dana Gas pleaded to be unlawful under UAE law; (b) the voidance of the Purchase Undertaking for common mistake that the Mudarabah Agreement and any related sale agreement will be valid under UAE law; and (c) English public policy prevents the enforcement of the obligations under the Purchase Undertaking when such enforcement will be unlawful under the laws of the UAE.

In November this year, the High Court rendered a preliminary judgment rejecting the arguments put forward by Dana Gas and ruling the English law governed Purchase Undertaking to be valid. In reaching this decision, the High Court (a) found Dana Gas’s obligation to pay the Exercise Price to the SPV independent from the ability to lawfully transfer the Mudarabah assets to the SPV; (b)

rejected the arguments of voidance of the Purchase Undertaking based on common mistake as the Purchase Undertaking effectively allocates the risk of mistakes to Dana Gas; and (c) rejected the public policy arguments as the obligations under the Purchase Undertaking do not require Dana Gas to do something unlawful “by the law of the country in which the act has to be done”.

The decision of the High Court is not surprising, and is in fact consistent with a statement in the prospectus for the Dana Gas sukuk offering, which notes that “prospective investors are reminded that Dana Gas has agreed under the English Law Documents to submit to the jurisdiction of the courts of England. In such circumstances, the judge will first apply English law rather than Sharia principles in determining the obligations of the parties.”

The case is still pending before the UAE courts to determine the validity and enforceability of the Mudarabah Agreement under UAE law. Although Dana Gas did not publicly reveal the advice it received from consultants stipulating that the outstanding sukuk are not Sharia compliant, media reports suggest that this advice was based upon (a) the pre-fixation of the Exercise Price; and (b) the

guarantee of a profit payment from the Mudarabah to the certificateholders, which they argue breaches Sharia law's principle that profit cannot be assured and the parties must share the risk in any transaction. As the elements of the Mudarabah causing it to be considered non-compliant with Sharia law are embedded in different transaction documents with different governing laws, the dispute raises challenging conflict of laws questions. While the Purchase Undertaking (which fixes the Exercise Price) is subject to English Law and the non-exclusive jurisdiction of English courts, and has recently been determined by the High Court to be valid under English Law, the Mudarabah Agreement (which sets the profit allocation between the *rab al-maal* (i.e. ultimately the certificateholders) and the *mudarib* (i.e. Dana gas)) is subject to UAE law and to the non-exclusive jurisdiction of UAE courts.

The decision of the UAE courts will largely depend on its interpretation of Sharia law. The role that Sharia law plays in the UAE, as well as several Middle Eastern jurisdictions, is two-fold. First, certain Sharia rules relating to financing arrangements are embedded in legislative instruments such that they constitute part of the country's law. In Dana Gas' case, a UAE court may find the *Mudarabah* agreement void for its non-compliance with the Sharia-inspired rules governing Mudarabah arrangements such as the prohibition on holding the *mudarib* liable for the loss in Mudarabah assets absent negligence from its part.<sup>3</sup> Secondly, Sharia law is considered a secondary source of law in

the UAE on matters not expressly regulated by legislation,<sup>4</sup> and, more importantly, a component of public order in the UAE.<sup>5</sup> Specifically, a UAE court could refuse to apply the rules of a foreign law in a dispute brought before it,<sup>6</sup> or deny enforcement of a foreign judgment,<sup>7</sup> on the basis that the foreign law or the foreign judgment conflicts with public order in the UAE, including Sharia law. Therefore, in the Dana Gas dispute, a UAE court could refuse to apply English law to the Purchase Undertaking (to the extent the court considers its validity), or deny enforcement of an English court judgment based on the enforceability of the Purchase Undertaking (including acknowledgment of the validity of the Purchase Undertaking as determined by the High Court), on the basis that the terms of the Purchase Undertaking violate Sharia law and are contrary to public order.

## The Outlook For Sukuk Market

The Middle East remains one of the most active regions for sovereign and corporate sukuk issuances, yet most legal systems in the Middle East lack certainty around Sharia rules governing these issuances. Despite the High Court ruling, if Dana Gas ultimately prevails in having the sukuk declared void for non-compliance with Sharia law, confidence in sukuk as a financing instrument will be significantly undermined. To avoid the uncertainty around the enforceability for an issuer's obligations based on their compliance with



the interpretation of Sharia law, investors could insist on subjecting all transactional documents, including the underlying sukuk structure, to the laws of a foreign jurisdiction that can offer certainty around the rules applicable to potential disputes. Investors could also require security packages in foreign jurisdictions that offer certainty around the enforcement of judgments issued for the investors' benefit.

**Uncertainty surrounding enforceability could be mitigated if investors:**

- insist on subjecting *all* transaction documents to consistently applied set of laws and court jurisdictions; and
- obtain security packages in foreign jurisdictions.

As such moves could raise the cost of sukuk issuance in the Middle East significantly, Middle Eastern countries may wish to consider legislative amendments to codify sharia rules applicable to sukuk transactions, leaving no room for different or unexpected interpretations of Sharia law applicable to the sukuk structure, with clear rules around the applicability of foreign laws and the enforceability of foreign judgments on sukuk disputes.

1. Dana Gas, *Dana Gas Outlines Broad Terms For Sukuk Discussions*, 13 June 2017.
2. *Ibid.*
3. Article 695 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
4. Article 1 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
5. Article 3 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
6. Article 27 of the UAE Federal Law No 5 of 1985 on Civil Transactions.
7. Article 235 of UAE Federal Civil Proceedings Law No 11 of 1992.



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Before joining Cleary, Mohamed worked with a leading Egyptian firm for two years, where he advised on various cross-border transaction. Mohamed has authored and published many papers in internationally recognized journals. Mohamed received his Master in Law degree from the Georgetown University Law Center and his diploma in law and bachelor's degree from the Cairo University, Faculty of Law.

# Debt To Equity Conversions in Nigeria: The Etisalat Case Study

By ADESEGUN AGBEBIYI



The 2015/2016 global crash in the price of crude oil caused a severe shock to the Nigerian economy, reliant as it is on this commodity for most of its foreign exchange earnings. The value of the Nigerian Naira is intricately linked to crude oil revenues, and the relationship is responsible for Nigeria's strength and stability in high oil price markets and its weakness and turbulence when the price of crude oil declines. A low oil price environment, particularly where the fall in price is precipitous, spells trouble for the Nigerian economy and introduces uncertainty into commercial transactions.

The oil price drop inevitably led to the Central Bank of Nigeria ("CBN") devaluing the Naira by about 30% over the course of the turbulence and rates on the parallel or "black market" fell as much as 50%, at its worst. The cost of dollar-denominated debt being much lower, at about 7%, than Naira debt, which

is between 20% and 25%, caused Nigerian corporates to go on a dollar-denominated debt binge during the boom years for the Nigerian economy. The devaluation of the Naira means that these corporates are now left with a large portfolio of dollar-denominated debt and higher debt repayments in Naira

terms. This coupled with a difficult operating environment and increased accounts payables, has left corporates struggling to repay creditors and maintain healthy debt and financial ratios.

The creditors are equally hampered by this situation. The loans can only be restructured so often, and ultimately, prudential guidelines, regulators and banks will demand hefty provisions for restructuring transactions involving what were once thought of as prime banking customers. As a result of these

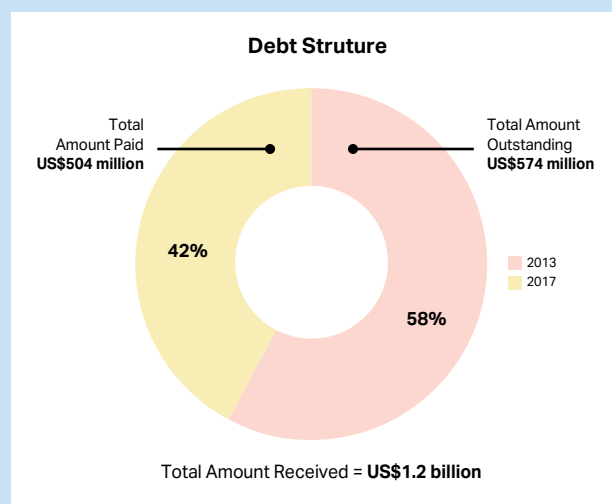
challenges, many Nigerian companies are left with few debt restructuring options and creditors are left with fewer options for recovering debt. The conversion of debt to equity is an option that may be considered to provide a lifeline to Nigerian companies, particularly those with good fundamentals but that are having solvency issues as a result of the devaluation of the Naira. Creditors are also impelled to consider the conversion of debt to equity as a realistic debt restructuring option when dealing with such distressed companies.

## CASE STUDY

### Etisalat U.A.E

#### The Etisalat EMTS Debacle

In 2013, Emerging Market Telecommunication Services (“EMTS”), the Nigerian subsidiary of Etisalat U.A.E. (“Etisalat”), obtained a U.S.\$1.2 billion (N377.4 billion) syndicated loan from a consortium of 13 Nigerian Banks (the “Banks”). The loan, which involved a foreign-backed guaranteed bond and a pledge of shares of all the shareholders, was to be used to finance a major network rehabilitation and upgrade and the expansion of its operational base in Nigeria.



EMTS had repaid 42% (about U.S.\$504 million) of the original U.S.\$1.2 billion loan with a total outstanding sum of about U.S.\$574 million when the oil price crash began. The loan was fully restructured in 2015 but EMTS defaulted on a payment due in February 2017. When the Banks threatened to take over the company, the relevant

Nigerian regulators, the Nigerian Communications Commission (“NCC”) and Central Bank of Nigeria (“CBN”), intervened. The Banks were persuaded to stay all actions and allow more time for further negotiations, to which all parties agreed and set a date of May 31, 2017 as the final deadline for repayment.

EMTS and Etisalat made an offer to convert the Banks’ outstanding dollar-denominated debt into 5% of the company’s equity. The syndicated loan on which EMTS missed a payment had a U.S. dollar portion of U.S.\$235 million outstanding, which EMTS wanted to convert into Naira in order to overcome hard currency shortages on Nigeria’s interbank market. The details of the offer were not made public but a valuation of 5% equity at U.S.\$235 million would have valued the company at a massive U.S.\$4.7 billion. The Banks did not accept the valuation or the offer and made good on their threat to take over EMTS after negotiations aimed at refinancing the debt failed. Etisalat announced that the Banks had exercised enforcement rights, requesting the transfer of 100% of the EMTS shares to the appointed trustee of the Banks. According to Etisalat’s filing at the Abu Dhabi Securities Exchange on June 20, 2017, Etisalat transferred all of its shares in EMTS (a 40% equity stake in the company) to United Capital Trustees Limited following receipt of a notice of default and security enforcement from the Banks on June 9, 2017. Mubadala, which reportedly owned 40% of the ordinary shares in the company, and the Nigerian shareholders that owned the remaining shares were also affected by the Banks’ exercise of their enforcement rights over their shares. All the shareholders were forced to transfer all their shares in EMTS to the Banks.

### **Negotiating the Conversion of Debt into Equity**

The aim of conversions of debt into equity is to strike a balance, not only between the relative amounts of debt to equity in order to ensure the company has an optimal capital structure for profitable operations, but also between a creditor and a debtor to ensure that the creditor is not essentially penalized for compromising its right to demand immediate payment and enforce its debt. However, issues may arise where the company in distress offers its creditors a negotiated amount of equity in exchange for their debt, which could lead to the creditors in turn driving negotiations by imposing particularly stringent requirements for the amount of equity they are to receive in exchange for their loan repayment and interest amounts.

EMTS, as a company in distress, would have hoped to lower its debt overhang and ultimately to avoid insolvency and the associated costs. From the perspective of the creditors, however, if they accepted an equitization of their debt, the best they could hope for would be that they become equity holders and strive to find a strategic or financial investor interested in acquiring EMTS with its valuable telecommunications license and 20 million subscriber base.

With the pressure from the CBN to classify EMTS's loan obligation as non-performing and increase their accounting provisions against non-performing loans, understandably the Banks' preference was for Etisalat to inject additional capital into EMTS to repay the portion of the principal and interest on the loan that had fallen due. The prospect of accepting equity and their right to repayment becoming patient capital would not have been appealing to the Banks as they are not private equity investors with the option of 5- to 7-year investment periods and would not be inclined to wait while EMTS tried to turn around its prospects. For a meaningful equity conversion offer to have been considered by the Banks, the first hurdle would have been to agree on an acceptable valuation for EMTS. The parties were very far from an agreement on this point. The offer of 5% of equity in EMTS in exchange for the U.S.\$235 million debt outstanding could not have been viewed as a serious offer as this would have valued EMTS at U.S.\$4.7 billion, as noted above, which was a clearly unrealistic value for the company at that time. These factors may have hastened the Banks's insistence on the enforcement of the share security.

In addition, the looming pressure from regulators did not create an ideal negotiating environment. The possibility that they would be allowed the time and space needed to negotiate and agree on a mutually acceptable structure for what is, even in favorable circumstances, a difficult and time consuming process was very slim. When EMTS initially defaulted on the loan in February 2017, the CBN and the NCC stepped in to prevent the Banks from immediately enforcing the security, but instead of focusing on resolving this fiasco, the NCC began making uncompromising statements about the Banks not being permitted to run a telecommunications company. The Banks were likely very reluctant to defer the process any longer and risk further regulatory interference and negative exposure. They likely determined it would be better to bite the bullet and enforce than risk losing the right to enforce all together. The approval of the Nigerian Securities and Exchange Commission ("SEC") may also have been required if the Banks sought to acquire control of EMTS since, though EMTS was a private company, it was a largely capitalized entity subject to the rules and regulations of the SEC .

Issuing new shares or exchanging unallotted shares for debt would have diluted Etisalat's shareholding in EMTS as well as the percentage holdings of other shareholders. The Nigerian shareholders of EMTS may also have had pre-emptive rights and, given reports in the market that they were yet to receive any dividends on their investment in the company after close to a decade of investment, the Banks would have been rightly weary of embarking on a process that would require their involvement or a waiver of any rights. Considering the issues above, the Banks refusal to acquiesce to the debt to equity conversion deal proposed by Etisalat and EMTS is perhaps understandable.

EMTS blamed its distressed situation on the economic downturn, and particularly the sharp devaluations of the Naira, which contributed in part to its repayment obligations increasing by almost 30% overnight. EMTS claimed that the business performed well in 2016 and had positive EBITDA. While the EMTS gambit failed miserably in this instance, the option to use debt to equity conversion was highlighted and perhaps if better handled may have helped to avoid the enforcement action by the Banks and preserved Etisalat's shareholding in EMTS, which at the time had 20 Million subscribers and represented 14%

of the telecommunications market in Nigeria. Specific circumstances aside, a company with a profile like EMTS would seem to be a good candidate for a debt to equity conversion.

The Banks are likely to try to sell EMTS as soon as possible and there have been media reports that international advisers have been appointed to manage the process and find a new investor willing to purchase the Banks' shares in Etisalat. It remains to be seen if there is any appetite in the market for strategic telecommunications investors or financial investors to acquire EMTS. As mentioned above, EMTS's fundamental position is very strong and it would be an appealing target for investors looking to enter the Nigerian market. It is unlikely that the most willing buyer, the South African telecommunications operator, MTN, the largest operator in Nigeria representing 36% of the market, would be allowed to acquire EMTS on the grounds

that this might enhance its already dominant position in the market. Etisalat and Vodacom, two international telecommunications operators with deep pockets, have exited the Nigerian telecommunications market and other international investors will be aware that it is a very competitive market and earning a return on investment will demand a great deal of skill and resilience.

The Banks may find that it would have been more beneficial to pursue the debt to equity conversion option with Etisalat more seriously. Etisalat may have been willing to accept a more reasonable valuation and the parties may have been able to agree on commercial terms that were mutually beneficial. A sale process may be time consuming and expensive and wouldn't be guaranteed to result in a viable buyer willing to accept the Banks' valuation of EMTS.

## Legal Regime for Debt to Equity Conversions in Nigeria

A debt to equity conversion in Nigeria may be implemented through a court-supervised process. Section 539 (1) of the Companies and Allied Matters Act ("CAMA") establishes a process for a Nigerian company to enter into a compromise or arrangement with its creditors or shareholders, whereby the rights and liabilities of members, debenture holders or creditors are governed by the provisions of CAMA or by the unanimous agreement of all parties affected. This process is subject to the approval of the Federal High Court in Nigeria after confirmation from the SEC that it is satisfied with the fairness of the applicable compromise or arrangement.

In practice, the court-supervised process is typically adopted in larger and more complex transactions, typically involving asset transfers. With more standard transactions, a simple contractual exchange to extinguish the debt of the creditor in exchange for equity in the borrower, a court supervised process would not be required.

### Documentation

Depending on the structure of the transaction, an amended facility agreement whereby parties recognize that the debt is reduced, a debt conversion agreement and a share purchase agreement may need to be executed by the parties. These agreements would reflect the outstanding debt of the debtor company (a portion of which would be converted as part of the

debt to equity exchange agreement), the shareholding of the investor/creditor as well as the terms governing the shareholders interest in the debtor company.

### Notable Regulatory and Legal Issues SHARE CAPITAL

In a debt to equity conversion, it is important that the debtor company has sufficient authorized but unissued share capital that can accommodate the debt conversion. Where the debtor company's share capital cannot accommodate the debt to equity conversion, a resolution of the shareholders increasing the capital will be required, authorizing the increase to an appropriate level. The shares would then be allotted and the necessary filings would need to be made at the Nigerian Corporate Affairs Commission ("CAC"). This capital increase is a corporate and administrative process that comes with an administrative cost implication as there are stamp duty and registration fees payable for the increase in share capital. These costs can however be moderated by the company reclassifying and issuing its new shares at a premium.

### REPATRIATION OF PROCEEDS

If the creditor is an offshore entity, the creditor may encounter difficulties in the conversion of the Certificate of Capital Importation ("CCI"). A CCI is the document that gives a non-Nigerian investor access to the foreign exchange market in order to repatriate dividends and proceeds from its investment in Nigeria. The applicable foreign exchange regulations provide that debt CCIs are issued in respect of the inflow of debt



from an investor to a local beneficiary and prescribe the specific document requirements to be complied with, in order for the interest and principal to be repatriated in accordance with the tenor and terms of the applicable underlying loan agreement. Similarly, with regard to equity investments by an investor into a local beneficiary, the specific document requirements are prescribed to permit repatriation of dividends and the proceeds of the sale of the shares to the non-Nigerian investor.

Consequently, if a debt to equity conversion occurs during the life of a loan, an incongruity arises between the investor and the beneficiary documents, as the investor will have the initial documents required to repatriate debt while its investment would have been converted into equity. The debt CCI will thus be required to be converted into or replaced with an equity CCI in favour of the investor. This conversion process may pose challenges as the CBN will be required to approve and authorise the conversion. This may delay the debt to equity conversion process as the CBN will typically require a detailed documentary history to prove that the funds were actually repatriated into Nigeria and that the investor/beneficiary of the funds complied with the provisions of the foreign exchange legislation at the time of the inflow of the funds.

#### TAXATION

Debt to equity conversions may also give rise to tax concerns, which should be analyzed on a transaction-by-transaction basis. For instance, Section 11(6) of Companies Income Tax Act (“CITA”) provides that interest on foreign loans that is not less than N150,000 would be exempt from tax, subject to certain

conditions. The third schedule to CITA details the repayment period and the respective tax percentage exemptions allowed on the interest of foreign loans as follows:

Repayment Period including Moratorium	Grace Period	Tax Exemption allowed
Above 7 years	Not less than 2 years	100%
5 – 7 years	Not less than 18 months	70%
2– 4 years	Not less than 12 months	40%
Below 2 years	Nil	Nil

Therefore, where the loans are initially structured to benefit from the above tax exemptions under CITA, a reduced withholding tax (“WHT”) liability would accrue on the interest payable on the loans based on the table above. A debt to equity conversion is deemed to constitute a discharge of the loan on the date of the conversion and WHT is assessed on the assumption that the principal and interest accrued on the loan have been repaid on the date of the conversion. If the conversion occurs outside of the repayment period originally contemplated by the debtor company, it is possible that the debtor company would lose the tax exemption it would otherwise have been eligible for on the repayment of the loan. For example, a debtor company that would have qualified for a 70% WHT exemption on a loan that should have been repaid between 5 and 7 years would lose this tax exemption if a debt to equity

conversion occurs after the seventh year of the loan. This could lead to unanticipated costs if parties are not mindful of the tax effects of such a debt to equity conversion.

A Capital Gains Tax (“CGT”) of 10% is levied pursuant to the Nigerian Capital Gains Tax Act on the proceeds of assets disposed of by a person. However, proceeds of the sale of shares are exempt from CGT, so creditors engaging in a debt to equity conversion would be able to take advantage of this tax exemption and would not be subject to any additional tax liabilities upon the disposal of their shares.

Note also that the valuation on the conversion of debt to equity must be commensurate with the actual price of the debt, otherwise, a conversion in which debt is exchanged for less equity than the value of the debt could be viewed as an unrealized gain for the debtor company, which would be treated as income and which would be subject to corporate tax.

## Conclusion

The oil price crash and the ensuing foreign exchange crisis that afflicted the Nigerian economy created difficulties in the repayment of foreign currency-denominated loans. Corporates and their financiers have been required to consider various options for debt restructuring in order to reduce the increased repayment burdens. A debt to equity conversion is an option worth considering in order to lift companies out of the financial dilemma generated by the devaluation of the Naira.

A debt to equity conversion is not without its challenges, as discussed above, but the benefits of a successful conversion would generally be worth the difficulties that may be encountered in the negotiating process. In the EMTS case, the Banks are left with the option of seeking investors to acquire EMTS and obtain a price proportionate to their outstanding debts owed by EMTS. These hurdles could have been avoided if the parties had agreed on commercially acceptable terms for a debt to equity conversion. It may be that there were simply too many parties involved for the debt to equity conversion option to have been viable with EMTS. Highly regulated commercial banks trying to restructure a regulated telecommunications company will inevitably face time and cost constraints that may end up sabotaging the transaction for all parties. Similarly, the unnecessarily high level of involvement of the CBN and the NCC in the EMTS case likely contributed to the Banks’ reluctance to move forward with the transaction at various stages. We expect that, in the future, regardless of the level of influence from regulators, more creditors in Nigeria will consider the debt to equity conversion option as a restructuring

solution, and will be able to learn from the EMTS case rather than dismissing the process as too cumbersome or fraught with regulatory hurdles. In turn, hopefully the Nigerian regulatory bodies will take a more hands-off approach to these types of transactions, which could ultimately contribute to a revitalization of the Nigerian economy as a whole. ■

1. Please note that the facts of this case were to a large extent culled from the reports of Nigerian daily newspapers, in particular, (*Business Day*).
2. The filing reference number is Ho<sup>2</sup>/GCF0/152/85.
3. The loans had originally been extended by the Banks to EMTS on the credit of Etisalat and Mubadala. The other shareholders, mainly local investors, lacked the financial strength or appetite to make additional investments in EMTS.
4. A patient capital investor is willing to make a financial investment in a company with no expectation of turning an immediate profit. Instead, the investor will forgo an immediate return, but will expect a more substantial return in the future.
5. Section 118 of the Investment and Securities Act, Cap I Laws of the Federation of Nigeria 2004 and Rule 434 of the Securities and Exchange Commission Rules 2013.
6. EMTS’s financial distress issues, laid out publicly on the pages of national daily newspapers, appear to have affected its operations as well. As of September 2017, its subscriber base had fallen to 17.2 Million and its percentage share of the market had decreased to 12.33%. See Nigerian Communications Commission, Industry Statistics, available at: <https://www.ncc.gov.ng/stakeholder/statistics-reports/industry-overview#view-graphs-tables-5>.
7. Camillus Eboh, Chijoke Ohuocha, *Nigeria’s 9mobile Seeks Concessions to Boost Revenues Ahead of Sale*, REUTERS (July 27, 2017), available at: <https://www.reuters.com/article/nigeria-9mobile/nigerias-9mobile-seeks-concessions-to-boost-revenues-ahead-of-sale-idUSL5N1KI6U9>.
8. Stamp duty fees of 0.75% of the increased amount and a graduated CAC fees commencing from N5,000.00 for every N1 million in share capital or part thereof to; N10,000.00 for every N1 million in share capital or part thereof for increases in share capital above N1 million and up to N500 million; and N7,500.00 for every N1 million in share capital or part thereof for increases above N500,000,000.
9. The foreign exchange market in Nigeria is regulated by the Foreign Exchange Monitoring and Miscellaneous Provision Act (“FEMM Act”), the CBN Foreign Exchange Manual and directives and circulars published pursuant to the FEMM Act and the Manual.
10. Laws of the Federation of Nigeria, Cap C1, 2004.



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## CHAPTER 15 WATCH / MULTI-JURISDICTION



# Azeri Restructuring Could Test Limits of Chapter 15 Foreign Plan Enforcement

By ELENA D. LOBO and DANIEL J. SOLTMAN

On December 12, 2017, the International Bank of Azerbaijan (the “IBA”), the national development bank and largest commercial and retail bank in the Republic of Azerbaijan, filed a motion in the United States Bankruptcy Court for the Southern District of New York, seeking permanent enforcement in the United States of its plan of reorganization that has been confirmed and substantially consummated in its Azeri proceeding (the “Azeri Plan”). The relief sought by the IBA in December 2017 follows the relief granted by the Bankruptcy Court in June 2017, when it recognized the IBA’s Azeri proceeding as a foreign main proceeding under Chapter 15 of the Bankruptcy Code,<sup>1</sup> overruling the objections of an ad hoc group of noteholders (the “Ad Hoc Group”), who argued that doing so would be manifestly contrary to United States’ public policy.<sup>2</sup> Written objections to permanent enforcement of the Azeri Plan are due on January 9, 2018, and a hearing is scheduled for January 18, 2018.<sup>3</sup>

## Chapter 15 Background

Unlike Chapter 11 of the Bankruptcy Code, through which a debtor (or debtors) can effectuate plenary restructurings, Chapter 15 proceedings are ancillary

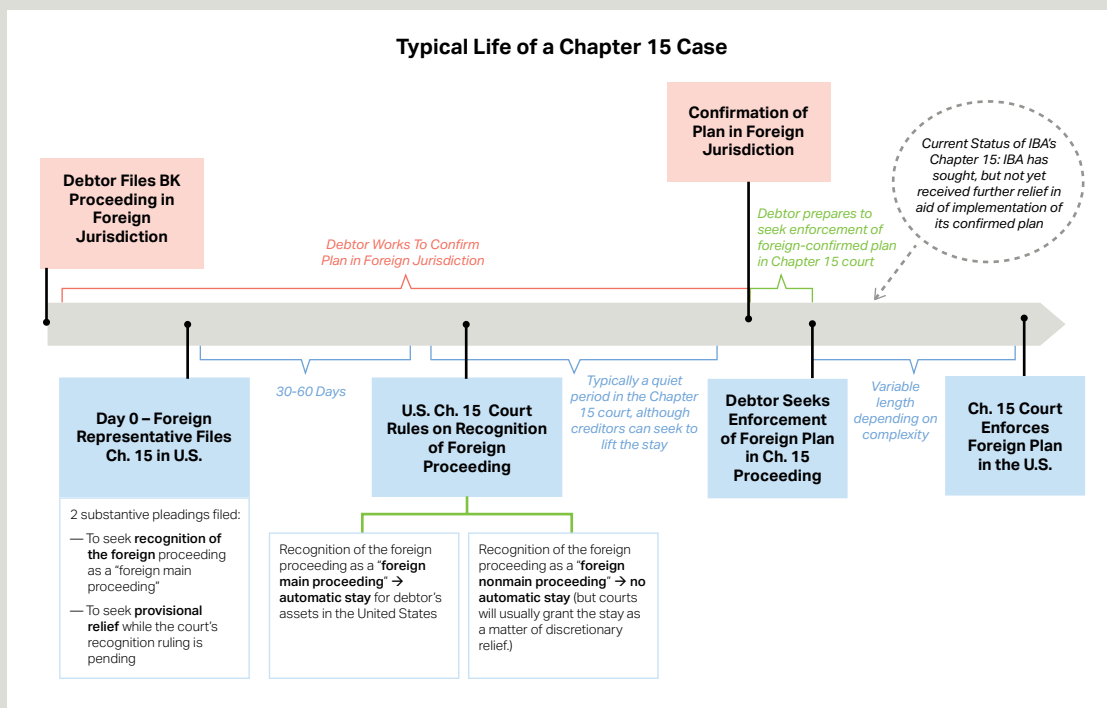
to proceedings in foreign jurisdictions, with the stated goal of “provid[ing] effective mechanisms for dealing with cases of cross-border insolvency”.<sup>4</sup> Accordingly, unlike a Chapter 11 proceeding, a Chapter 15 proceeding can only exist where a proceeding already exists in a foreign jurisdiction.

Although all cases are unique, there are typically two flash points of activity over the life of a Chapter 15 proceeding: *first*, when the Chapter 15 proceeding is first filed and the debtor’s foreign representative seeks “recognition” of the foreign proceeding; and *second*, after a plan has been approved in the foreign jurisdiction, when the debtor’s foreign representative will seek relief in aid of implementation of the confirmed plan.<sup>5</sup> As of this publication, relief is pending in the second stage.<sup>6</sup>

## The IBA’s Chapter 15 Petition for Foreign Main Proceeding Recognition

On April 16, 2017, the Azerbaijan legislature enacted new restructuring provisions (the “Azeri Restructuring Law”) that allow for the voluntary





restructuring of financial institutions in Azerbaijan, and which appear tailor-made for the IBA.<sup>7</sup> The day after the new Azeri Restructuring Law was enacted, the IBA’s supervisory board proposed the commencement of a judicial reorganization proceeding under the new law, and the following week the IBA had submitted a draft of its Azeri Plan and applied for a proceeding with the Nasimi District Court. On May 4, 2017, the Nasimi District Court granted the application and the Azeri proceeding commenced.

Shortly after the commencement of the Azeri proceeding, the IBA defaulted on a substantial portion of its debt and became increasingly vulnerable to creditor action, particularly regarding its U.S. Dollar-denominated debt and U.S. accounts. According to its Chapter 15 petition, the IBA sought Chapter 15 relief in order to safeguard its U.S. accounts from attachment or set-off, to guard itself against parallel U.S. lawsuits brought by non-Azeri creditors and to obtain U.S. judicial recognition of the Azeri proceeding, and eventually enforcement of the Azeri Plan, to be able to restructure its U.S. Dollar-denominated debt. The IBA asserted in its Chapter 15 petition that a loss of access to its

U.S. accounts and ability to carry out U.S. Dollar-denominated transactions, would cause severe harm to the IBA and, due to the IBA’s involvement and influence in Azerbaijan’s business and infrastructure projects, the Azerbaijan economy as a result.

## The Ad Hoc Group’s Objection to Recognition

The Ad Hoc Group responded to the IBA’s Chapter 15 petition by filing an objection<sup>8</sup> that sets forth its arguments against recognition by the Chapter 15 court and focuses on its objections to the new Azeri Restructuring Law.

The Ad Hoc Group’s chief argument was that the Azeri Restructuring Law fundamentally violates U.S. laws and policies and that, as such, the Bankruptcy Court should deny recognition of the Azeri proceeding because it does not meet the “minimal level of procedural and substantive fairness” required by Chapter 15.<sup>9</sup> The Ad Hoc Group’s objection asserts that the Azeri Restructuring Law does not provide any meaningful protections

for creditors, particularly for non-Azeri creditors, evidenced in part by the fact that creditors with disparate treatment are permitted to vote together in the same class, there are no restrictions on counting insider votes, there are no provisions for avoiding fraudulent transfers and there is no requirement that the debtor's assets be used to satisfy outstanding claims. Another feature that the Ad Hoc Group highlights in its objection is that, under the Azeri Plan, all of the IBA's foreign (non-AZN) denominated debt is impaired, while equity and AZN-denominated debt would be left unimpaired.<sup>10</sup> As a result, unsecured creditors (who are owed U.S.\$2.38 billion) would take significant haircuts. These features, the Ad Hoc Group argued, substantiate the Ad Hoc Group's argument that the Azeri Restructuring Law and the Azeri proceeding, are "designed to enhance the value of the Republic's equity in the IBA, at the expense of foreign creditors", in direct conflict with the legal and political foundation of Chapter 15 and thus manifestly contrary to U.S. public policy.<sup>11</sup>

### The Bankruptcy Court's Recognition Decision

In the June 28, 2017 ruling from the bench, in which it overruled the Ad Hoc Group's objections and recognized the Azeri proceeding as a foreign main proceeding, the Bankruptcy Court was careful to make clear that it was *not* deciding on the substantive objections raised by the Ad Hoc Group at that

time. Specifically, the Bankruptcy Court explained that "[a]ll that is before the Court is the authorized representative's request pursuant to Section 1517 of the Bankruptcy Code that the Court recognize the authorized representative as IBA's foreign representative, recognize the Azeri proceeding as a foreign main proceeding, and grant the automatic effects attendant with recognition under Section 1520 of the Bankruptcy Code, including the application of the automatic stay under Section 362 to IBA and IBA's property within the territorial jurisdiction of the United States."<sup>12</sup> As such, Judge Garrity went on to explain that "[i]n reality, the bondholders' objection is a preemptive strike against the IBA plan"<sup>13</sup>, that the objection would be better formulated if and when the IBA returns to the Bankruptcy Court to seek enforcement of a confirmed plan, and that the standalone act of recognizing the Azeri proceeding "will not undermine in any way any U.S. policy and granting stay relief that the authorized representative is presently seeking is hardly inconsistent with U.S. policy."<sup>14</sup>

**Recognizing the Azeri proceeding as a foreign main proceeding "will not undermine in any way any U.S. policy and granting stay relief that the authorized representative is presently seeking is hardly inconsistent with U.S. policy"**

*United States Bankruptcy Court for the Southern District of New York, June 28, 2017*



## What to Watch For

Ultimately, the recognition of the Azeri proceeding as a foreign main proceeding is unsurprising. The Bankruptcy Court's ruling is simply the latest in a long line of decisions that narrowly construe the public policy exception to grant relief under Chapter 15 of the Bankruptcy Code, particularly at the initial stage when all that is sought is recognition of the foreign proceeding and stay relief.<sup>15</sup> The real test for the Azeri Restructuring Law in the Chapter 15 context will come if and when any creditor files an objection to the IBA's motion for plan enforcement, at which time the Bankruptcy Court may have to grapple with the substantive objections it was able to avoid, given the relatively limited stay relief that results automatically from recognition of a foreign main proceeding.<sup>16</sup>

1. An order was formally entered on July 7, 2017. See *In re Int'l Bank of Azerbaijan*, Case No. 17-11311 (JLG) (Dkt. 38). All further pleading references herein are to the same docket.
2. See 11 U.S.C. § 1506.
3. This Issue No. 5 of the Cleary Gottlieb Emerging Markets Restructuring Journal went into production before the January 9, 2018 objection deadline.
4. 11 U.S.C. § 1501(a).
5. Where appropriate, motions for recognition and plan enforcement may be combined.
6. For a more detailed overview of the Chapter 15 recognition and enforcement process, see James L. Bromley and Daniel J. Soltman, "U.S. Chapter 15 Overview", *The Restructuring Review of the Americas 2018*, *Global Restructuring Review*, August 16, 2017, available at <http://globalrestructuringreview.com/benchmarking/the-restructuring-review-of-the-americas-2018/1145713/us-chapter-15-overview>.
7. These provisions were enacted in the form of an amendment to the Law of the Republic of Azerbaijan on Banks.
8. Dkt. 22.
9. *Id.*, ¶ 23.
10. In its response to the Ad Hoc Group's objection, the IBA responded to the allegations of discrimination against foreign denominated debt by noting that "[w]hen claiming prejudice against foreign creditors, the Ad Hoc Group ignores the most important fact: that IBA has no Azeri-denominated debts other than its customer deposits and certain low-cost loans that allow the [IBA] to provide important business services to its customers at competitive rates." Dkt. 23, ¶ 27.
11. Dkt. 22, ¶ 15.
12. Dkt. 39 at 17-18.
13. See *id.* at 19.
14. See *id.* at 19-20.

15. Only a few Chapter 15 courts have ever relied on the public policy exception in refusing to grant relief, and reliance on the public policy exception at the proceeding recognition stage (as opposed to the plan enforcement stage) is even more rare.

16. As noted above, written objections are due on January 9, 2018 and a hearing is scheduled for January 18, 2018. In its motion for permanent enforcement of its Azeri Plan, the IBA noted that the Azeri Plan was approved in Azerbaijan with 93.9% in amount of total claims subject to the restructuring voting in favor of the plan, and to the best of its knowledge, only one member of the Ad Hoc Group that objected to recognition had voted against the Azeri Plan in the Azeri proceeding. See Dkt. 22, ¶¶ 41, 44. Accordingly, it is not clear at this time whether the Ad Hoc Group will revive the substantive objections it raised in its objection to recognition.



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# Ukrainian Distressed Debt Market: New Investment Opportunities

By YULIA KYRPA and BOHDAN DMUKHOVSKYY



## Overview of the distressed debt market in Ukraine

The variety and volumes of distressed debt currently available for purchase in Ukraine are likely to be the most attractive over the last decade. This is due to a number of reasons that have had an impact on the Ukrainian economy, including its banking sector. The roots of the current financial distress originate from the global financial crisis of 2007-2008, which was further intensified in Ukraine by the political turmoil of 2013-2014 and the military operations in the East and South of the country that started in 2014. These factors led to the bankruptcy of a significant number of Ukrainian banks, a cautious lending policy of the banks that remained solvent and significant hardships for the refinancing of debt of Ukrainian borrowers in domestic and in international financial markets.



Since 2014, the National Bank of Ukraine (the “NBU”) and the Deposit Guarantee Fund (the “DGF”), which, among others, is responsible for the management of resolution procedures of insolvent banks, have started bank resolution procedures with respect to more than 90 banks, almost all of which are now subject to liquidation. In early 2017, the NBU announced that the banking system “purification” period is over and no more substantial bank insolvencies are expected in the coming years, unless the Ukrainian economy becomes subject to any further stress from outside factors.

In the period from 2014 to 2016, the DGF acquired a debt portfolio in an amount exceeding UAH 400 billion (approximately U.S.\$15 billion), containing the assets of the insolvent banks, the biggest part of which consists of loans provided to Ukrainian borrowers (in excess of UAH 300 billion, approximately U.S.\$11.4 billion).

The DGF is planning to sell all these assets within the next four to five years to cover:

- claims of the insolvent banks’ creditors, and
- the DGF’s indebtedness to the Ministry of Finance of Ukraine which as of the end of 2016 amounted to more than UAH 125 billion (approximately U.S.\$4.5 billion) and consisted of the principal and interest accrued on the loans extended by the Ministry of Finance of Ukraine to the DGF from the state budget in order to compensate the amounts of individuals’ deposits insured by the state.

Under the current regulatory regime, the amount of assets that the DGF has been able to sell has been comparatively low. For example, in the first nine months of 2017 the DGF managed to sell loans in the aggregate amount of UAH 11,800 million (approximately U.S.\$445 million) for the total purchase price of UAH 2,889.1 million (approximately U.S.\$109 million). Since 2014 the DGF has sold only approximately 15% of the total loan portfolio under its management. It is expected, however, that by the end of 2017 the DGF will significantly accelerate the sale of assets through implementation of sales mechanisms that are discussed below in detail.

Thus, the DGF has already become the major market player on the sell-side in the Ukrainian distressed debt market. The banks that remained solvent also have high levels of non-performing loans (the “NPLs”), reaching up to 30% of their balance sheets. The solvent banks, however, generally choose to manage their NPLs internally.

## Legislative and regulatory framework

When investing in NPLs, either purchased from the DGF or a solvent bank, buyers need to consider certain legislative and regulatory requirements in order to comply with when structuring the transactions.

## Registration Requirements

In particular, Ukrainian regulations<sup>1</sup> require registration with the NBU of a loan provided by a foreign entity or individual to a Ukrainian resident. Until recently, registration was not feasible without the borrower's cooperation. Due to liberalization of applicable regulations in early 2017<sup>2</sup>, a borrower's cooperation is no longer mandatory. However, the registration requirement still applies. In practice, this means that any assignment of loans from Ukrainian banks, including DGF-managed banks, to foreign investors must be registered with the NBU. The registration process requires a submission of a formal application to the NBU together with the relevant transaction documents and takes approximately one month after the date of filing with the NBU.

## Other Restrictions and Possible Solutions

There are also certain restrictions with respect to the loans provided or acquired by foreign creditors that need to be considered, in particular:

Temporary prepayment prohibition (may be lifted in 2018 depending on macro-economic factors)	
Limitation on the maximum interest rate	<b>Fixed interest loans:</b>
	<b>Term</b> <b>Interest Cap</b>
	Up to 1 year                      9.8% per annum
	1 to 3 years                      10% per annum
	More than 3 years                      11% per annum
	<b>Floating interest loans:</b>
	<b>Term</b> <b>Interest Cap</b>
	Up to 3 years                      3-month LIBOR + 750 bps

To avoid these restrictions and the loan registration procedures, foreign investors usually establish an SPV in Ukraine that purchases the loan portfolios on their behalf. Establishing a Ukrainian SPV usually helps to solve these matters as the loan registration requirement is not applicable to local creditors irrespective of the nationality/domicile of their ultimate beneficial owners.

Until recently, only duly registered Ukrainian financial institutions were entitled to purchase loans at the auctions held by the DGF. However, this requirement was abolished in January 2017. The only applicable restriction for the potential buyers is that the borrower itself and any of its guarantors are not entitled to purchase loans from the DGF. It is also worth noting that non-registration of a Ukrainian SPV as a financial institution puts some limits on its capacity in relation to the acquired loans. In particular, after an acquisition of a loan (including a loan from a DGF-managed bank) by such SPV, interest on the outstanding amount of such loan will no longer accrue<sup>3</sup>.

In addition, in order to receive payments in foreign currency, the SPV needs to obtain a general foreign currency license. Alternatively, an SPV may engage a solvent Ukrainian bank to receive the payments in foreign currency on behalf of the SPV and convert them into UAH before transferring the funds to the SPV.

When considering whether to incorporate an SPV, an investor should also take into account certain temporary restrictions imposed by the NBU, which include, in particular, a temporary prohibition on payment of dividends abroad by the SPV, which the NBU partially softened in 2016 and in April 2017 and expects to lift soon completely. In particular, the NBU changed the regulation from a complete prohibition on dividends payment to permission for payment of those dividends that were calculated for 2014-2016 in the amounts not exceeding U.S.\$5 million per month.

## NPL Assignment Procedures

Apart from the above considerations, the NPLs assignment and sale procedure are rather straightforward. The seller and the buyer normally enter into a written loan sale or assignment agreement. This agreement only needs to be notarized if specifically agreed by the parties or if the loan is secured by a mortgage. Upon execution of the agreement and payment of the purchase price, all rights and obligations under the loans and the underlying security agreements are transferred to the buyer and the buyer will need to be registered by the notary in public registers instead of the seller as the new mortgagor and pledgor.

Loan sale transactions normally do not raise any antimonopoly regulation issues and do not require prior clearance with the Antimonopoly Committee of Ukraine or other authorities.

## Distressed debt portfolio acquisition strategies

For the purposes of organizing sales of the NPLs, the DGF established a special Consolidated Asset Sales and Management Office at the end of 2015, which is in charge of all procedures related to the sale of loans by DGF-managed insolvent banks. Other offices within the DGF structure remain in charge of implementation of other bank resolution procedures, collection of fees from the bank-participants of the deposit insurance system and distribution of guaranteed deposits.

According to applicable law<sup>4</sup>, the DGF may sell the assets via an auction or directly to an interested buyer. The value of the assets available for sale directly to an interested buyer must not exceed UAH 32,000 (approximately U.S.\$1,000). Such values are appraised by an independent appraiser contracted by the

DGF. Accordingly, NPLs above this *de minimis* threshold are always sold via auctions.

Until October 2017, the loans were sold only via the English forward action (i.e. an open-outcry ascending auction) for single loan sales. Recently, the DGF has approved special regulations allowing additional types of auction:

- English forward auction for portfolio loan sales;
- Dutch auction for single loan sales; and
- Dutch auction for portfolio loan sales.

#### **English forward action for single loan sales**

The DGF has developed an auction process in partnership with the Ukrainian online sales system called ProZorro.Sale. The system was developed at the initiative of the Ministry of Economic Development and Trade of Ukraine in cooperation with Transparency International, the DGF and the NBU to create a platform for buyers of state and/or municipal owned property and has been already recognized internationally for its innovative approach<sup>5</sup>. This is the first centralized online platform used for the sale of state property in Ukraine with the potential for strong transaction analytics, including big data techniques.

ProZorro.Sale is a centrally managed dynamic database of information regarding the lots put up for sale by state authorities, including the DGF. The database is managed by the NGO “Transparency International Ukraine”. A bidder may receive access to the database through any of the 30 private local Ukrainian sales platforms that have been accredited by the DGF and cooperate with the central database on equal terms. The auction includes two stages: (i) the bidders provide sealed bids, and (ii) the sealed bids are opened and disclosed to other participants (redacting the bidders’ names), and a few rounds of open bidding are held.

Such integration of the DGF’s auctions into one platform significantly improved the speed of sales and removed certain corrupt practices which commonly happened within the framework of former procedures. At the same time, until recently, ProZorro.Sale processed auctions only on the principle of English forward action for single loan sales, i.e. allowed only one ascending auction for each asset. The overall volume of sales, therefore, remained low taking into account a huge portfolio of assets of the insolvent banks and its quick depreciation.

#### **Portfolio sales and Dutch auction**

In order to overcome the drawbacks of the ascending auctions for single loan sales, the DGF is currently finalizing the legal and technical infrastructure for alternative auction types:

- English forward auction for portfolio loan sales;
- Dutch auction for single loan sales; and
- Dutch auction for portfolio loan sales.

The DGF intends to try different combinations of these types of auctions to reach the maximum sales volumes per month. For example, single loans may be sold through either an English or a Dutch auction, or pooled into portfolios in such a way so that they are comprised of high-value loans provided to affiliated corporate borrowers and/or borrowers from the same business sectors and include the security package related to such loans. It is therefore expected that the new auction types will attract strong international investment and will significantly increase sales volumes.

#### **Alternative strategies**

Applicable law<sup>6</sup> also allows several other ways for acquisitions of distressed loans from the DGF. These alternatives, however, are legally and procedurally more complicated and time-consuming. For instance:

- an investor may purchase an insolvent bank from the DGF together with its loan portfolio. As evidenced by few completed transactions, in practice, this scenario is more attractive to investors who expect to be doing banking business in Ukraine rather than to engage in asset enforcement and/or restructuring; and
- a solvent Ukrainian bank may purchase a loan portfolio of an insolvent bank together with the related obligations of such insolvent bank. A recent notable deal of this kind involves an undertaking by Taskombank to pay out insured deposits of individual depositors of the insolvent Diamantbank equal to UAH 1.2 billion (approximately U.S.\$45 million) in exchange for title to the same amount of Diamantbank’s loans. To implement structures like this, a foreign investor will need to partner up with a local Ukrainian bank.

Considering the above, a sophisticated buyer should be able to execute a deal aimed at profitable portfolio acquisition, having invested sufficient time in the due diligence exercise followed-up by the development of an appropriate enforcement strategy.

## Debt recovery strategies: restructuring vs. enforcement

Prior to an acquisition, a reasonable investor should also understand the potential recovery strategies in relation to the target portfolio. In light of recent financial distress, Ukrainian authorities have revised and significantly updated the legal framework for both restructuring and enforcement procedures<sup>7</sup>.

### Restructuring

Restructuring is generally a preferable option in relation to loans granted to Ukrainian businesses which are in strategic default. Indeed, many medium-sized and large Ukrainian companies have decided to default intentionally on the loans from Ukrainian banks immediately after they became aware of the NBU's decision to start resolution procedures in relation to the insolvent banks. In many cases, such businesses also have their core assets pledged in favour of the insolvent banks and still have cash on hand.

When going for the restructuring option, an investor may choose either to restructure the indebtedness based on the general provisions of contract and civil law or to use a special regulation, the so-called "Kyiv Approach". The choice of the "Kyiv Approach" provides the borrowers with a number of benefits, which are not available in general civil law procedures, for example: tax incentives, prompt resolution of disputes, elimination of bankruptcy risks and alignment of the commercial interests of multiple creditors. The "Kyiv Approach" aims to incorporate the best practices of the "London Approach"<sup>8</sup> into Ukrainian legislation.

The relevant Law of Ukraine "On Financial Restructuring" (the "Restructuring Law"), dated 14 June 2016, establishing the "Kyiv Approach", entered into force on 19 October 2016 and will remain effective until October 2019<sup>9</sup>. The Restructuring Law provides for a voluntary restructuring procedure which may be pursued by borrowers unable to fulfil their financial obligations. The following are key features of the Restructuring Law:

<b>New Special Administrative Bodies</b>	Special non-governmental bodies have been established for the administration and coordination of the restructuring process as well as resolution of disputes: these are the Secretariat, the Supervisory Council and the Arbitration Committee.
<b>Creditors' List</b>	At least one domestic or foreign financial institution which provided or acquired the loan has to be included into the creditors' list.  The proceedings are initiated by the borrower who also determines the list of creditors involved in the restructuring. The list must include state bodies that are creditors of the debtor (for instance, tax authorities) and those financial institutions not affiliated with the borrower, which own 50% or more of the borrower's debt. Other creditors are included at the borrower's sole discretion.
<b>Affiliates</b>	The parties affiliated with the borrower who have their own monetary claims against that borrower are excluded from voting at the creditors' meeting when the decision on the approval of the restructuring plan is adopted.
<b>Plan Approval</b>	The restructuring plan has to be approved by all creditors involved in the restructuring or by 2/3 of the creditors and the arbitrators appointed by the Arbitration Committee.  The Arbitration Committee selects arbitrators from the list approved by the Supervisory Board that includes highly reputable lawyers with significant experience in arbitration and commercial/financial matters. While resolving the case regarding approval of the restructuring plan, the arbitrator shall take into account written comments of all creditors and issue his/her decision with eighteen days as of receipt of the filing from the debtor.
<b>Plan Binding Force</b>	The conditions of the approved restructuring plan are mandatory and binding for all creditors involved, the borrower, its related parties and guarantors (the approved conditions are not mandatory for other creditors).
<b>Tax Incentives</b>	Tax incentives for parties participating in the restructuring. These advantages attract many borrowers to participate in the procedures envisaged by the Restructuring Law, which has increased the number of successful debt restructurings in Ukraine.



### Enforcement

Enforcement may be preferable over restructuring in relation to the loans secured with valuable collateral, which does not constitute a part of the debtors' core business, or in relation to insolvent debtors, whose financial rehabilitation is not feasible. When proceeding with the enforcement option, an investor may run into a number of legal loopholes and malevolent practices that allow Ukrainian borrowers to avoid or substantially delay the repayment of debt. Such impediments include the initiation of bankruptcy proceeding by the borrower, a corrupt judiciary and ineffective enforcement system. Hence, investors should be aware of such legal impediments in advance in order to minimize their effect on the expected return from the deal.

The Ukrainian Parliament has taken significant steps towards implementation of a reform of the court system. In particular, in 2016, a law was passed<sup>10</sup>, providing, among others, for:

- an establishment of the new anticorruption and intellectual property courts;
- new principles of competitive selection of judges;
- the examination of thousands of judges<sup>11</sup>;
- weakening the immunity of judges; and
- the reappointment of judges to the Supreme Court on a competitive basis.

Most of the provisions of the law have been successfully implemented to fight corruption in Ukraine's judicial system.

As to enforcement proceedings, in 2016, the Parliament passed two laws aimed at substantial reformation of the Ukrainian enforcement system: (i) the Law "On Enforcement Proceedings"; and (ii) the Law "On Agencies and Persons Engaged in Enforcement of Court Decisions and Decisions of Other Bodies" (together, the "Enforcement Laws").

The main novelty of the Enforcement Laws is an introduction of the institute of private enforcement officers – qualified specialists entitled to enforce court decisions and decisions of other governmental bodies alongside the State Enforcement Agency (except for certain types of decisions specified by the Enforcement Laws, such as decisions involving the state, governmental bodies or state-owned enterprises, decisions on property seizure, home eviction of individuals, etc.). In 2017, the first private enforcement officers began providing their services to lenders.

Other progressive initiatives include, among others, (i) formation of the Unified Debtors Register, which is already operational and accessible to the public at the following address: <https://erb.minjust.gov.ua>, (ii) computerization of enforcement procedures (including electronic registration of documents and documentation of all decisions and procedural acts in the system), (iii) increasing the liability of debtors within enforcement proceedings, as well as (iv) an increase in the amount of penalties which may be imposed by enforcement officers.

Certain other legal loopholes, such as limited powers of secured borrowers in bankruptcy procedures, still have not received sufficient attention from the Ukrainian Parliament and are not expected to be remedied in the near future. These factors should be considered by an investor when deciding on the pricing of NPLs and a post-closing strategy.

## Market exit strategies: peculiarities of the secondary distressed debt sales

Investors' exit strategies may include a re-sale of the NPL portfolio to other interested parties. In order to complete such a re-sale, an NPL-holder must be registered as a financial institution in Ukraine. Moreover, unlike with the initial purchase, the subsequent purchaser of the NPLs must also have the status of a financial institution or a bank in Ukraine in order to be able to dispose of a loan.

In order to obtain the status of a financial institution, the NPL holder needs to be registered with the National Commission for Regulation of the Financial Services Markets (the "FMA"). Registration procedures include, among others, requirements relating to the internal regulations, personnel, accounting and reporting systems, technical equipment and capital. In addition, a financial institution is not allowed to engage in business other than the provision of financial services. Applicable regulations<sup>12</sup> set forth capital requirements for certain categories of financial institutions. In particular, a financial institution's own capital shall not be less than:

- UAH 3 million (approximately U.S.\$100,000) for applicants planning to engage in one category of financial services; and
- UAH 5 million (approximately U.S.\$200,000) for applicants planning to engage in two or more categories of financial services.

Registration procedures may take from two to six months. In light of the above requirements, it is recommended to plan exit strategies in advance prior to the completion of the NPL purchase transaction, and to decide whether the investor intends to re-sell the NPLs further. In case the re-sale of the NPLs is anticipated, an incorporation of an SPV in Ukraine in the form of a financial institution will be required.

In conclusion, given the significant development of the NPL market in Ukraine over the past two years, strengthened by the consistent improvement of the legal framework, the Ukrainian NPL market has become more attractive for foreign investors. However, purchase and exit strategies should be carefully structured to mitigate local risks in light of the relatively new and untested regulatory innovations. ■

1. Regulation on the Procedure for Receipt of Foreign Currency Loans by Residents from Non-residents and Extension of Foreign Currency Loans by Residents to Non-residents, as approved by the Order of the Board of the National Bank of Ukraine, No. 270 dated 17 June 2004, as amended
2. Order of the Board of the National Bank of Ukraine "On Amendment of Certain Regulations of the National Bank of Ukraine", No. 26 dated 23 March
3. It is worth noting that interest still accrues on the loans of the banks while they are managed by the DGF
4. Art. 51 of the Law of Ukraine "On Deposit Guarantee System", No. 4452-VI dated 23 February 2012, as amended.

5. For instance, it is a winner of the Citi Tech for Integrity Challenge (T4I) Award.
6. The Law of Ukraine "On Deposit Guarantee System", No. 4452-VI dated 23 February 2012, as amended
7. In particular, the Ukrainian parliament passed the Law of Ukraine "On Financial Restructuring", No. 1414-VIII dated 14 June 2016, and the Law of Ukraine "On Enforcement Proceedings", No. 1404-VIII dated 02 June 2016, as amended
8. A set of informal guidelines on a collective process for voluntary workouts to restructure debts of corporates in distress, developed under the leadership of the Bank of England, is generally referred to as the "London Approach"
9. The Restructuring Law terminates on this date. Depending, however, on the macroeconomic situation in Ukraine, its effectiveness may be extended by the parliament.
10. The Law of Ukraine "On Court System and Status of Judges", No. 1402-VIII dated 02 June 2016, as amended
11. Special anti-corruption authorities have been created (e.g. National Anticorruption Bureau of Ukraine), which perform examination of all judges based on their public tax declarations and re-examination of professional fitness of judges
12. Section XI of the Regulation on the State Register of Financial Institutions as approved by the Order of FMA, No. 41 dated 28 August 2003, as amended



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Yulia holds a Master of Law from Taras Shevchenko National University in Kyiv, Ukraine and obtained her MBA from Heriot-Watt University in Edinburgh, United Kingdom. During the financial crisis, Yulia developed a number of innovative legal products in demand by banks, financial institutions and corporations. FT Innovative Lawyers (Europe) 2015 named Yulia "an outstanding specialist in the field of banking and finance law, at a time of immense challenges" and listed her among Top 10 Legal Innovators of the Year in Europe.



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# Venezuela's Imminent Restructuring and the Role Alter Ego Claims May Play in this Chavismo Saga<sup>1</sup>

By RICHARD J. COOPER and BOAZ S. MORAG



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,<sup>2</sup> 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.<sup>3</sup> Because PDVSA is directly majority-owned by Venezuela, PDVSA is an "instrumentality" also protected by the FSIA.<sup>4</sup> 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.<sup>5</sup>

Other than immune diplomatic property, Venezuela has no known unencumbered commercial assets in its own name in the United States.<sup>6</sup> 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.<sup>7</sup>

### 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).<sup>8</sup> 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.<sup>9</sup> That confirmation, obtained in March 2017,<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> Crystallex initiated a lawsuit in November 2015, *Crystallex Int'l Corp. v. Petróleos de Venezuela, S.A.* ("Crystallex I"),<sup>13</sup> under the Delaware Uniform Fraudulent Transfer Act,<sup>14</sup> 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.<sup>15</sup>

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*”).<sup>16</sup> 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*.

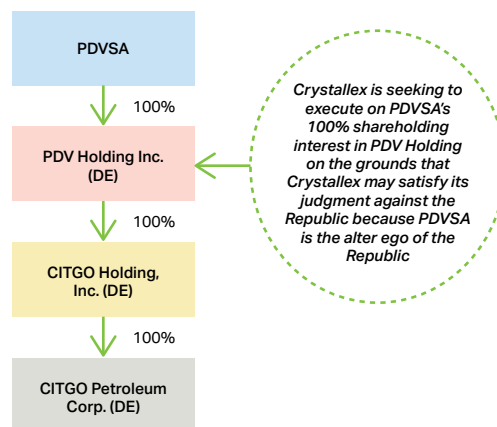
Crystallex’s reliance on DUFTA to challenge these transactions ultimately will turn on whether DUFTA can be used to rescind or unwind a transaction in which the debtor (Venezuela) caused assets that allegedly would otherwise have been available for execution in the United States to be transferred to 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*”),<sup>17</sup> 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.<sup>18</sup> 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.<sup>19</sup> 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”).<sup>20</sup> 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.<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup> 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."<sup>24</sup>

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."<sup>25</sup> Crystallex alleges the Venezuelan government exercises significant day-to-day control over PDVSA.

First, Crystallex argues that Venezuela ignores PDVSA's separate corporate form.<sup>26</sup> It argues that Venezuela incorporated PDVSA to implement government policy, pointing to the "Nationalization Law" published in Venezuela's Official Gazette.<sup>27</sup> 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.<sup>28</sup> However, courts have repeatedly held that the government's appointment of directors and officers, without more, is not enough to overcome corporate separateness.<sup>29</sup> 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.<sup>30</sup>



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.<sup>31</sup> 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.<sup>32</sup> 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.<sup>33</sup> 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.<sup>34</sup>

Crystallex alleges that Venezuela uses PDVSA property as its own.<sup>35</sup> 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.<sup>36</sup> Crystallex also alleges that PDVSA paid Venezuela's arbitration costs in

the present case,<sup>37</sup> 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.<sup>38</sup>

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

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.'"<sup>44</sup> 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.<sup>45</sup> 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.

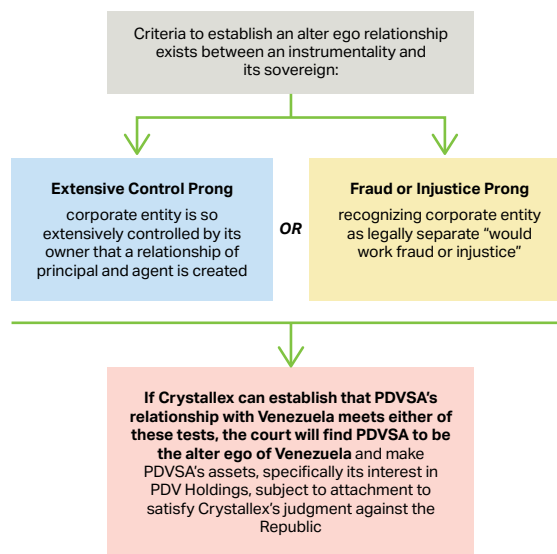
Crystallex argues that Venezuela gave PDVSA, by official decree and for no consideration, the very mineral rights that Venezuela expropriated from Crystallex.<sup>46</sup> Crystallex notes that PDVSA then sold the government 40% of the interests in the land for approximately US \$2.4 billion, and that the government officially designated PDVSA the "expropriating entity" for the state, effecting numerous other expropriations with PDVSA's involvement.<sup>47</sup> 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."<sup>48</sup>

### 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.<sup>49</sup> 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.<sup>50</sup> 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.

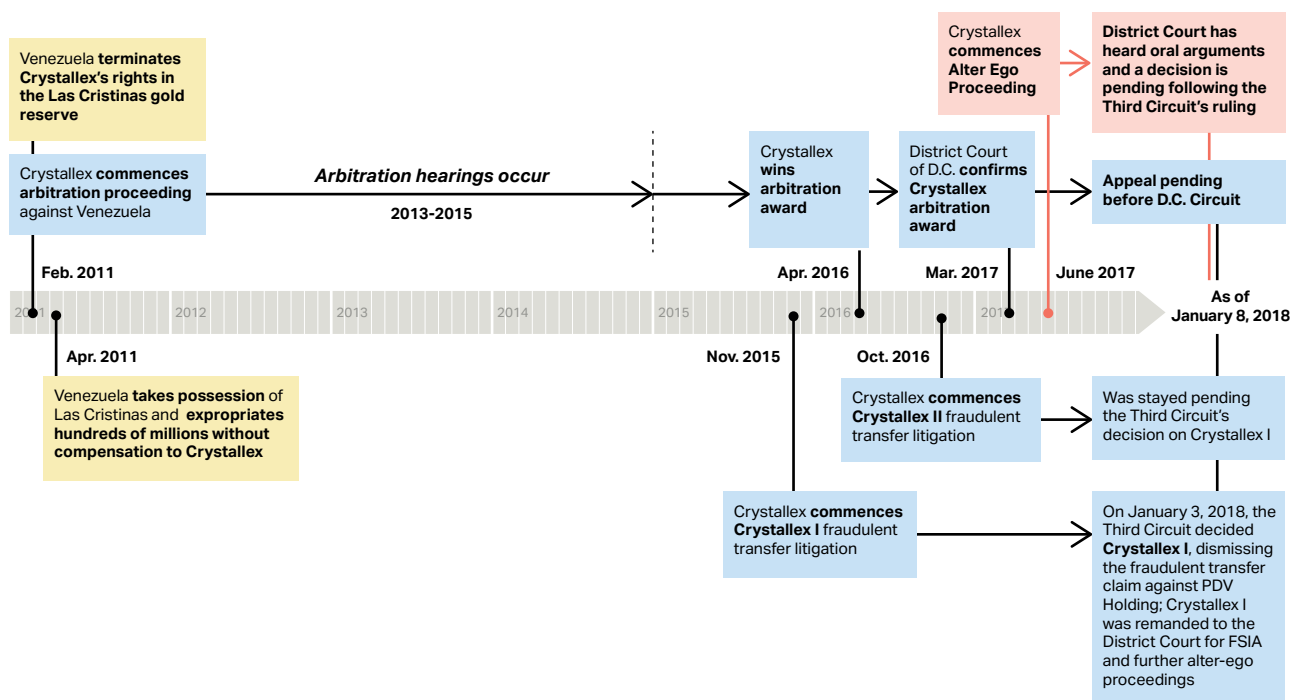
#### Keys To Alter Ego Proceeding



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.<sup>51</sup> 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.<sup>52</sup> 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.<sup>53</sup>

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

## Crystallex Litigation Timeline



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."<sup>54</sup> 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.<sup>55</sup> 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.<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup>

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.<sup>59</sup> 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-crystallex-fraudulent-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](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 Turkmen.*, 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 *Bancetec*]”).
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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Boaz has extensive experience with complex commercial disputes, as well as with disputes over sovereign immunity under United States law and over the scope and applicability of various bilateral and multilateral treaties and conventions. He has represented the Russian Federation, the Republic of Slovenia, the Republic of Serbia, the Republic of Iraq, the Republic of Congo and Grenada in arbitration and litigation proceedings over sovereign debt, state succession and other issues.

The authors thank Mihalis Gousgounis, Philip Cantwell and Emily Michael for their assistance with this article. Mihalis and Philip are associates, and Emily is a law clerk, in the New York office of Cleary Gottlieb.

Counsel to **The Commonwealth of Puerto Rico** with the financial restructuring of U.S. **\$73 billion** of indebtedness.

**Restructuring Deal of the Year**  
**OAS SA**

*International Financial Law Review, 2017*

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Counsel to Steering Committee of Bondholder Creditors in Brazilian telecom **Oi's** restructuring of **U.S. \$20 billion** of liabilities (**largest ever Latin American bankruptcy**).



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**Global Finance Deal of the Year: Insolvency and Restructuring (Latin America): Enel Américas corporate reorganization**

*The American Lawyer's Global Legal Awards, 2017*

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Counsel to the **Republic of Côte d'Ivoire** in a **\$1.25 billion** Reg S/Rule 144A and concurrent **€625 million** Reg S notes offering.

Counsel to **UC RUSAL** in its **\$5.15 billion** restructuring and its previous **\$16.8 billion** restructuring, the largest-ever restructuring of a company with main operations in Russia and the CIS.

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