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Guest post

The PDVSA 2020 bond: time for a solution

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Dr. Arturo C. Porzecanski, a distinguished economist in residence at the American University, is an expert in international finance and sovereign debt issues. He was formerly chief emerging-markets economist at various major banks in New York. In this post, he argues that, rather than litigating, bondholders and the Guaidó administration, should now sit down and negotiate a reprofiling of the PDVSA 2020 bond.

Venezuela's default on over $60bn of government bonds sold around the globe turns two years old this month – the most protracted sovereign default of the past two decades, but for Argentina's default in late 2001. It has now widened to encompass even the PDVSA 2020 – the collateralised bond issued by state oil company PDVSA – amortising notes, of which $3.4bn were issued in late 2016. A $913m payment of principal and interest is overdue since October 28.

This was the government's last performing dollar bond, and it is notable because it was backed like no other by very desirable collateral: a controlling (50.1 percent) stake in Venezuela's most important asset abroad, the Houston-based refiner Citgo, which if auctioned off could fetch $4-8bn.

President Nicolás Maduro serviced the PDVSA 2020 bond throughout 2017-18 because he feared the political repercussions of losing what Venezuelans consider to be a "crown jewel" in a vast field of badly managed state-owned enterprises. For the same reason, he has also honoured a loan from the

Russian energy giant Rosneft, to whom Maduro pledged the remaining stake in Citgo as collateral.

Earlier this year, interim president Juan Guaidó appointed shadow administrative boards for Citgo and PDVSA. Those are recognised by the US government – and thus US courts – as legitimate bodies with authority over the companies' affairs.

Running Citgo in this manner is feasible because it operates wholly in the United States, and thus out of Maduro's reach. However, PDVSA's parallel board exercises only fictional control, because its directors are in exile while most of the company's assets are in Venezuela, operating under Maduro's thumb.

Most importantly, Guaidó's representatives have no access to Venezuela's oil export earnings. The proceeds still flow to Caracas and sustain the Maduro regime, having been successfully diverted through Russian and other foreign banks, and also courtesy of Rosneft, to bypass otherwise crippling US sanctions.

Guaidó's side has access to Citgo's cash and to certain Venezuelan government funds blocked in US bank accounts. They enabled Guaidó to make a payment of $71m to cover last April's coupon on the 2020 bond – because he too is loath to surrender Citgo to its creditors, lest he lose political support back home. However, coming up with $913m to cover principal and interest due on October 28 was a very tall order.

The only reason why bondholders have not already exercised their rights to Citgo is because, four days earlier, the Trump administration amended US Treasury sanctions on Venezuela to order a postponement of all dealings related to the PDVSA 2020 bond until January 22. Mr Guaidó's representatives in Washington had lobbied the US government heavily for some such protective measure.

Guaidó decides to play offense

Rather than sitting down and negotiating with the bondholders, however, on October 29 Guaidó's team filed a lawsuit in US federal court on behalf of PDVSA, and against the 2020 bond trustee and collateral agent (Union Bank and GLAS Americas, respectively). It seeks a judgment that the bond's indenture should be annulled and declared unenforceable, thereby barring any exercise rights on the Citgo collateral.

The argument put forth is that, because in 2016 President Maduro failed to submit the proposed indenture for consideration by the opposition-controlled

legislature (the National Assembly), the indenture and its security agreement are invalid. Moreover, it is claimed that investors should have avoided the bonds because the Assembly had adopted a resolution publicly denouncing the transaction then in motion.

The Guaidó litigation recalls the old legal doctrine of "odious debt". It argues that sovereign debt incurred without the consent of the people, and not benefiting the people, should not be transferable to a successor government, especially if creditors are aware of these facts ahead of time. However, notwithstanding the passage of almost a century since it was first articulated, this doctrine has gained zero traction within the international legal community, despite the many instances of corrupt despots whose legacies of indebtedness could have been challenged.

The lawsuit is a Hail Mary pass. First, the PDVSA 2020 transaction did not raise any new funding for the Maduro regime to misuse; it merely refinanced large payments coming due that could not be met. Second, PDVSA has never requested authorisation from the National Assembly to incur debt, so what transpired was business as usual.

Third, US legal precedents suggest that when a government expressly represents that a bond is properly authorised, investors are entitled to rely on that representation. And to recall, the bond is subject to New York law, not Venezuelan law. Fourth, earlier this year the National Assembly voted unanimously to make the aforementioned coupon payment, thereby legitimising the obligation it had denounced in 2016.

Time to solve the underlying problem

The countdown to January 22 has begun, and thus time is of the essence. It is exceedingly unlikely that a court judgment – never mind a ruling in Guaidó's favour – will be rendered before then. And even if it is, a lengthy appeal process is likely to follow.

Come mid-January, the Trump administration might or might not be persuaded to extend the current freeze on transactions related to the PDVSA 2020 bond. But even if it does grant an extension, that will only postpone, rather than solve, the impasse between bondholders and PDVSA.

There is a realistic risk that the US Treasury will lift the prohibition on the said transactions. One reason is that there is growing resistance on Wall Street and in conservative circles to the US government's running roughshod over investor rights and lawful contracts. Another is the September ouster of John

Bolton from the White House, because the national security adviser reportedly was the loudest advocate of unseating President Maduro.

Therefore, it behoves both sides in the dispute – bondholders and Guaidó's representatives – to start an earnest negotiation process to solve the underlying problem, which is PDVSA's current incapacity to meet the contractual terms of the 2020 bonds. And since it is impossible to assess PDVSA's future ability to meet its financial obligations, particularly given dwindling oil production in Venezuela, an agreed postponement of the remaining principal repayments is probably a good first step.

It makes sense for Venezuela to spare at least one bond from protracted default and steep investor losses. While it will be tough for PDVSA to eventually regain access to the international capital markets, its re-entry will be greatly facilitated if investors can recall that at least one collateralised obligation was treated with the respect and seniority it deserved.

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