Market Intelligence

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Global interview panel led by Paul, Weiss, Rifkind, Wharton & Garrison LLP

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Getting The Deal Through

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Venezuela

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1 In the past year, have you seen any developments or trends in the nature and volume of insolvency filings? (For example, are certain industry segments experiencing a rise in distressed situations?)

To understand the Venezuelan situation in general and particularly current insolvency practice, we need to focus on the general context. During 2018, the sustained economic crisis affecting Venezuela evolved into a full humanitarian emergency, with the highest inflation rate in the world. In 2020, the humanitarian emergency, aggravated by the covid-19 health crisis, continued, as did the hyper-inflation process. Furthermore, during the past few years a tenth of the population has emigrated, oil production has plummeted and the accumulated loss of gross domestic product over the past eight years is reported to have exceeded 74%, with a further 30% expected for 2020 according to United Nations Economic Commission for Latin America and the Caribbean projections. The country's functional reserves are at their lowest levels and the local currency substantially depreciates on a daily basis. Regarding foreign currency exchange, during 2019 and 2020 the Central Bank let the official exchange rate soar to the level of the unofficial parallel market and a de facto dollarisation is occurring, which the monetary authorities tolerate, and this has led to a situation that is difficult to read regarding economic possibilities.

The Venezuelan government and state-owned companies have defaulted and no organised restructuring negotiations are expected to occur any time soon, despite public announcements that the Venezuelan finance minister is proposing to restructure the country's foreign debt. Foreign sanctions, particularly US sanctions, are also in place. These sanctions began targeting individual government officials and later evolved to apply to transactions involving the government, including state-owned companies (now blocked by the sanctions). This affects oil production and commercialisation and, in practice, impedes the negotiation of new debt and dealings on equity belonging to Venezuela or Venezuelan state-owned companies, among others.

From a political perspective, the government controls all public institutions, except the National Assembly (the Venezuelan parliament), which was elected in 2015. However, elections for a new National Assembly were due in December 2020 (in accordance with the Constitution), and a disputed electoral process took place on 6 December 2020, in a context where the main opposition parties and their political leaders had been banned by the electoral authorities, resulting in a boycott by the opposition. The results, in which 91% of seats went to the United Socialist Party (which has been in power since 2000), were rejected by the Organization of American States, Canada, the United States and most members of the European Union.

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Previously, in 2017, the government had created a "Constitutional Assembly", purportedly to draft a new Constitution, but, in practice, this entity unconstitutionally took over the state's legislative function, displacing and de facto annulling the National Assembly. The Constitutional Assembly was not recognised by most western democracies, including the United States, Canada and most of Europe. In December 2020, the Constitutional Assembly ceased its functions without producing a new draft of the Constitution. In a similarly rejected process, in May 2018, presidential elections were held at the behest of the Constitutional Assembly. The resulting re-election of the incumbent President for a further six-year term (beginning on 10 January 2019) has not been recognised internationally, with very few exceptions. Instead, the United States, Canada and many countries in Latin America and Europe have recognised the then president of the National Assembly as the country's interim president since January 2019.

Technically, approval from the National Assembly is necessary to issue new debt and this approval has been denied to the government up to now. On 5 January 2021, the new, contested, National Assembly assumes its functions, and the matter will again come up. Most probably, the contested National Assembly will approve

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the issue of new debt, but the still active 2015 National Assembly will not issue the required approvals.

From a commerce and industry perspective, the government has taken important measures to control economic activities, taking a very aggressive and confrontational stance against the private sector and implementing regulations that have only worsened the situation following the government measures in response to the covid-19 pandemic. Government officials have threatened private sector companies and individuals not only in general terms, but also, and more specifically, by persecuting and outlawing conduct leading to the cessation of economic activities by privately owned companies, which have been threatened with confiscation or expropriation if they "close their doors".

In sum, Venezuelan companies face complicated economic conditions and, in some cases, it is very difficult for them to operate at a profit, or at least without losses. In the few cases where they have been able to accumulate profits, exchange controls were used to prevent shareholders from receiving dividends and capital repatriations.

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Further, according to different sources (such as Consecomercio, Conindustria and Fedecamaras, private sector commercial and industrial syndicates), many companies have actually stopped operating. However, we see few formal insolvency filings. We believe this is because political issues and threats affect insolvency practice in Venezuela. In analysing some examples, we find things like the following.

First, during the past few years, many companies have suffered significant capital losses because of different factors, including the foreign exchange distortions and the recent economic impact of covid-19 on commerce and services. This has meant that, under Venezuelan law, their shareholders were required to reimburse losses and capital, reduce capital stock or liquidate the company.

Second, transnational companies with a presence in Venezuela have seen significant losses abroad because of their local results, which because of generally accepted accounting principles are reflected in their consolidated financial statements. Accordingly, transnational corporations have had to make decisions regarding their activities in our country. Many have decided to deconsolidate their Venezuelan subsidiaries, others have decided to sell their assets or business in Venezuela and others still have taken the hit.

Third, both national and transnational companies find that doing business in Venezuela is fraught with difficulties and, in some cases, not even profitable. However, many continue to manufacture and sell products and services because of the political context. In some cases, in the hope that political and economic circumstances may change. Some companies have adjusted to a market that is less than 20% of what it was four years ago. In other cases, even though many operations translate into losses, the alternative – closing shop – may actually be worse because it implies expropriation of assets and total loss of the investment. Clorox, Kimberley-Clark, Smurfitt Kappa and Kellogg's took this road and the result was the seizing of their assets by the government – a de facto expropriation – with no compensation.

In this context, filing for insolvency is probably not a good option and that is what our practice has reflected. Indeed, rather than helping our clients file insolvency claims, we have had to advise them on how to dramatically downsize or reduce operations to a minimum without crossing the threshold where confiscation might happen. In other cases, we have helped them reimburse capital losses and deal with the financial and legal aspects of their equity insufficiencies. However, in other cases and on the other side of transactions, we have helped clients seize opportunities to buy the subsidiaries of foreign companies in Venezuela, thus relieving the head offices of targeted companies from the problems of owning their Venezuelan businesses while placing a stake in the local market in preparation for change.

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Yet there is another different and very important issue to consider: the insolvency of the public sector. In November 2017, we saw for the first time late payments of debt by the Bolivarian Republic of Venezuela and its state-owned company Petróleos de Venezuela, SA (PDVSA). Since then, with certain exceptions, payments have stopped in what is now considered a full default of the state, PDVSA and Elecar bonds. Up to November 2019, the exception was the PDVSA 2020 bond, which is, in theory, secured with part of Citgo's shares. But even in that case, a default occurred in November 2019, when neither the incumbent government not the interim government paid the amount due. Also, in November 2019, the interim government initiated a judicial procedure requesting that the New York courts declare the nullity of the bond and also the nullity of the corresponding guarantee over the shares. On 16 October 2020, there was a decision declaring that PDVSA 2020 bonds are "legal, valid and enforceable".

Further, the economic sanctions imposed by the United States have affected Venezuelan debt, including bonds, in different ways. For instance, the Venezuelan government, including its state-owned companies, have been designated "blocked persons" and US persons (as defined in the sanctions programme) may not deal, negotiate or transact operations with them, neither may US persons deal in "new debt" (which includes restructuring "old debt"). In practice, this impedes an ordered restructuring. The interim president and his designated authorities are exempted from the limitations applicable to blocked persons and therefore may be instrumental in reaching agreement with bondholders, but the limitation regarding new debt still applies. In addition, the sanctions programme has established protections for the Venezuelan state from creditors in the execution of judicial decisions (although in the case of the PDVSA 2020 bond, an exception to this protection exists and enters into force on 21 July 2021). Creditors have been organising possible courses of action, hence the insolvency of the public sector is a major issue and many factors – including among others an interim government, the non-recognition of the National Assembly "elected" on 6 December 2020 and foreign sanctions – may affect the way the situation resolves itself.

2 | Describe the one or two most notable insolvency filings in your jurisdiction in the past year.

In the very unconventional scenario described, there have been several cases of companies closing shop reported by industrial and commercial associations. Indeed, according to the president of Conindustria, four-fifths of all industrial companies have closed in the past 20 years and 43% of current companies could shut down their operations this year. Further, the president of Consecomercio estimated a

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> "Because of the covid-19 health crisis, the Supreme Tribunal of Justice ordered the suspension of judicial activities from 16 March 2020 to 5 October 2020."

drop of 32% in consumer demand and declared that between 20 and 30% of the commercial and services sector are debating whether they should close, change areas or gravitate to the informal economy.

However, insolvency proceedings are few and not at all prominent. Indeed, neither the press nor colleagues report notable cases of insolvency proceedings (in the judicial sense of the term) in the private sector, possibly because of the very special circumstances already described. Because of the covid-19 health crisis, the Supreme Tribunal of Justice ordered the suspension of judicial activities (except for "urgent cases", constitutional complaints and criminal courts) from 16 March 2020 to 5 October 2020, and as a result, all insolvency filings were paralysed for almost seven months.

Nonetheless, we must highlight the current default of the state and its state-owned companies regarding payments of bonds and promissory notes, which we believe will eventually lead both to very complicated negotiations involving foreign creditors, bondholders and financial institutions, and to multiple lawsuits and arbitration proceedings before foreign tribunals and arbitration venues.

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3 | Have there been any recent legislative reforms? Is there a perceived need for reform?

No, there have been no legislative reforms concerning insolvency in Venezuela. In fact, the Commercial Code, which regulates the insolvency regimes of bankruptcy and moratorium, has been in force since 1955. Since the origin of the rules currently in force can be traced back to the 19th century, there is indeed need for reform. Many scholars favour an approach where the principle of continuity of the company informs the rules on the bankruptcy and moratorium procedures.

Two attempts were made to reform the rules: the first in 1966 and the second in 1988. We shall refer to the most recent one, which was led by our late partner Leopoldo Borjas, who proposed a law on bankruptcy. The draft law incorporated many changes, updating certain rules and including relevant foreign law provisions, with the idea of changing the insolvency rules to seek continuity of the business, rather than simple protection of creditors. However, neither the 1966 nor the 1988 proposals were approved and thus the rules regulating insolvency still date back, in essence, more than a 100 years.

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The need for reform is also evident when one considers the effects when the very slow and formal legal procedures for insolvency in Venezuela collide with a hyperinflationary economy, where delays may mean the almost total disappearance of any remaining assets.

4 In the international insolvency field, have there been any legislative or case law developments in terms of coordination of cross-border cases? What jurisdictions are you most likely to have contact with?

We must again refer to this very unusual context that characterises the Venezuelan situation. In this context, the most likely developments to take place will involve the all-out default of Venezuela regarding payment of bonds and promissory notes, either by the central government and its instrumentalities or through its state-owned companies, PDVSA or Elecar.

We believe that eventually there will be negotiations for a debt restructuring process. However, any such negotiations will be affected by the following: the need for the approval of the National Assembly, especially in view of the perceived illegitimacy of the "elections" held on 6 December 2020 and the persistence of the 1915 National Assembly; the perceived illegitimacy of the re-election of the incumbent president from 10 January 2019 and the recognition of the interim president by the United States and most of Europe and Latin America; and the sanctions that have been imposed by the United States, among others.

In addition, as explained earlier, international companies have dealt with losses by their Venezuelan subsidiaries in fundamentally three ways: selling the subsidiaries; deconsolidating their financial statements; or assuming the losses.

5 In your country, is there a particular court or jurisdiction that sees a higher concentration of insolvency filings? What is the attraction of that forum?

As we explained previously, there are few proceedings regarding either the moratorium process or bankruptcy.

6 Is it fair to describe your jurisdiction as either "debtor-friendly" or "creditor-friendly" in terms of how insolvency filings proceed?

In general terms, from a procedural standpoint, the Venezuelan regulations on insolvency are creditor-friendly. As we commented earlier, these rules are outdated and, indeed, strictly speaking, the main concept behind them is the protection of

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creditors; that is, they are designed to organise creditors and to help them recover their credits from the patrimony of the debtor, as the patrimony stands at the time of bankruptcy.

However, since the rules have not been modernised, they do not reflect a broader understanding of the concept of the protection of creditors. We refer to the idea that by helping the debtor recover or continue in business creditors may have a higher chance of fully recovering their interest. As we have stated, neither do the rules reflect the principle of continuity of business, which is an even more modern approach to the protection of creditors. Regarding specific creditors, the general rules of the Commercial Code establish two types of creditors: common creditors and creditors who have privileges or are beneficiaries of security interests. In very simple terms, the latter have pre-eminence over the former. But there is an unspoken additional advantage given to a particular kind of privileged creditor: workers, who are favoured over all other creditors. The tax administration is also a privileged creditor.

The Venezuelan legal system is characterised by a very overprotective set of rules regarding workers from the standpoints of both working relationships and social contributions. Additionally, courts (not only labour ones) have a general tendency to protect workers over all other parties involved in disputes. Accordingly, courts tend to favour payment to workers over any other creditor. Yet, as stated above, this is not necessarily beneficial to the workers in the long term. Other solutions that provide continuity of business and thus allow workers to keep their jobs could actually be more useful to the workers than simply receiving severance payments in the amounts allowed by assets liquidated in the bankruptcy procedure (especially in the context of hyperinflation). Finding different approaches, such as capitalising severance payment credits or liquidating part of the pool of workers to make the company viable may be a better solution in the long run. However, as stated, our regulations require important reforms to allow a more business-oriented approach to prevail and our judges need a better understanding of the long-term benefits for both businesses and creditors in general and workers in particular.

7 What opportunities exist for businesses wanting to purchase assets out of an insolvency, and how efficient is the process? What are the best ways to take advantage of opportunities in this area?

As stated earlier, because of the very *sui generis* situation regarding insolvency in Venezuela, we believe our country is a buyers' market.

Strictly speaking, buying assets out of an insolvency proceeding is complicated in Venezuela, because liquidation of assets should follow these steps: first, for real

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"The Venezuelan legal system is characterised by a very overprotective set of rules regarding workers from the standpoints of both working relationships and social contributions."

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estate to be sold, the judge must approve the sale; and second, all other assets must be sold at auction (even though the judge may authorise private sales).

Despite this, buyers have great opportunities outside insolvency proceedings but within general insolvency situations – or even in situations that do not amount to insolvency but do involve accounting losses or important risks associated with political issues. Indeed, as indicated, there are unconventional opportunities available for individuals and corporations with a certain degree of risk tolerance. For instance, opportunities to acquire subsidiaries of transnational corporations are an indirect way to acquire assets that could otherwise ultimately be involved in an insolvency or other risky situations. In fact, because of the economic and political situation, prices are currently low. We have seen several acquisitions in the past years in Venezuela and have worked on some very interesting ones in which our clients were the acquirers.

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The Inside Track

What two things should a client consider when choosing counsel for a complex insolvency filing in this jurisdiction?

Obviously, extensive knowledge and practice regarding corporate finance and law are indispensable. However, two more characteristics are also extremely necessary: first, a solid and transparent judicial practice, that is, a litigation department that is both knowledgeable and experienced in procedural law and transparent in its dealings with the judiciary. Second, a solid labour department, because workers tend to be a determining factor in insolvency proceedings because of the worker-friendly tendency of the Venezuelan legal regime and its application by the courts. Accordingly, when choosing counsel, we recommend not only extensive corporate experience, but also a trusted litigation and labour practice.

What are the most important factors for a client to consider and address to successfully implement a complex insolvency filing in your jurisdiction?

Filing for insolvency tends to be complicated in Venezuela nowadays because of non-legal issues. Indeed, political issues such as confiscation and expropriation threats suggest that it is better to deal with insolvency outside the courts, because filing may result in the shareholders losing not only their company, as a business, but also their investment. In fact, when filing for bankruptcy in a normal context, shareholders may receive assets after creditors have been satisfied; however, in the current circumstances, filing for bankruptcy may translate into de facto expropriation, where shareholders are barely compensated for their shares, if at all.

What was the most noteworthy filing that you have worked on recently?

In the present very unconventional context, as we have explained, rather than assisting our clients with insolvency claims, we have helped them to deal legally with equity insufficiencies and to acquire subsidiaries sold by transnational corporations and we have advised them in expropriation procedures and the like. Notwithstanding the current situation, some years ago, when conditions were different, we handled one of the main insolvency proceedings in Venezuela: the moratorium proceeding filed by Venepal, CA, the leading pulp and paper producer in Venezuela, which then evolved into a bankruptcy proceeding and ended, finally, in an expropriation. We acted as counsel to Venepal and its shareholders.

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