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Restructuring on the rise for Venezuelan companies

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Venezuela's economic crisis continues and many experts anticipate that the situation will get worse.

Its currency is grossly devalued due in large part to the country's black market for the US dollar. Inflation is high, and will likely only increase in the next few years. Moreover, the recent steep drop in oil prices has significantly impacted the country's major export sector, petroleum, and has created stress for Venezuelan companies with liabilities denominated in foreign currency. The government-owned oil company, Petroleos de Venezuela SA (PDVSA), is particularly vulnerable given its large issuances of US dollar denominated bonds. Indeed, PDVSA has $10.8 billion of interest and principal payments on its US bonds due in 2016.

Without any improvement expected in the near future, PDVSA and other similarly situated Venezuelan companies may be unable to continue servicing their foreign currency denominated debt and will need to consider strategies for restructuring. However, Venezuela's existing bankruptcy law is not a meaningful option, as it is antiquated and does not provide a viable mechanism for reorganisation. More realistic solutions for these companies are out-of-court workouts or Chapter 11 plans of reorganisation under the bankruptcy laws of the US.

Venezuela's economic crisis

According to the International Monetary Fund, Venezuela's economy will shrink by at least 10 per cent in the next year. Several elements have contributed to this continued downward spiral, including the devaluation of the bolivar, high inflation rates and the contraction of oil exports. Deflated oil prices and failed economic policy are largely to blame.

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The current inflation rate in Venezuela is at about 124 per cent – the highest in the world – but research predicts it will be at 1,500 per cent by 2017. Venezuela's currency has tanked. In 2013, the bolivar was worth US$4, now it's worth about 11 US cents. As a result, poverty rates have also increased. Venezuelans paid in bolivars have found their salaries diminished due to the increase in prices for household goods. Moreover, access to the US dollar is controlled by a complex three-tiered exchange rate. The government's strict currency controls have only resulted in the formation of the black market for dollars and this has further aggravated the devaluation of the bolivar; according to Bloomberg, a dollar stretches 150 times farther on the black market

Venezuela's economy is very reliant on the petroleum sector. In fact, revenue from the country's petroleum exports accounts for more than 50 per cent of the GDP and roughly 95 per cent of total exports. Falling oil prices have therefore had a catastrophic impact on the economy. Venezuela's current leadership blames the country's oil troubles on an economic war waged by the United States and Colombia. But the government's efforts to influence OPEC policies – such as suggesting the limiting of production or the establishing of a US$70 per barrel oil floor, have been unsuccessful.

Nearly half of Venezuela's foreign debt is owed by companies in the oil industry – including PDVSA. The country owes about $3 billion in interest in the first quarter of 2016, half of what the country is expected to reap in oil revenues for the same time period. Analysts also estimate that it has a total of US$10.8 billion of interest and principal payments on US bonds coming due over the course of the year. Given the significant drop in oil prices, analysts believe Venezuela will not be able to stave off a default. They estimate a $27 billion financing gap with a 73 per cent probability that PDVSA will default by September 2016.

Currently, PDVSA has a large profile of debt issued in the US. This profile includes US$4.05 billion 8.5 per cent 2017 bonds – half of which are due in 2016 and the other half in 2017. In October 2015, the company paid almost $5 billion in interest payments that went toward these and other notes, as well as $685 million in coupon payments. Nevertheless, PDVSA's credit ratings remain poor.

In December, Fitch Ratings affirmed PDVSA's foreign and local currency Issuer Default Ratings at "CCC." Fitch also affirmed a "CCC/RR4" rating for PDVSA's approximately US$30 billion of senior unsecured debt outstanding. Fitch warns of the impending default and identifies PDVSA's link to the government and limited transparency as key drivers of its credit quality. Fitch's "CCC" rating suggests a real possibility of default.

The *El Mundo* daily stated that PDVSA is planning to renegotiate some of its 2016 and 2017 debt, but provided no more details. If PDVSA does move forward with a restructuring, Fitch anticipates an average recovery for bondholders between 31 per cent and 50 per cent. However, Venezuela's likely unwillingness to offer bondholders concessions will place actual recovery on the lower end of that range.

Options for restructuring US dollar debt

Also on the mind of bondholders is what avenue PDVSA (and other Venezuelan issuers) will use to address the need for a restructuring, and whether such an avenue, or avenues, will maximise the return to investors and address any issues related to executing and finalising same.

These concerns are exacerbated by a Venezuelan insolvency law that is antiquated and ill prepared to address the type of large and complex cross-border financial restructuring that Venezuelan companies will need to achieve to preserve their going concern value. Without a viable home country restructuring law, PDVSA and others will need to consider other options.

Venezuela's Insolvency Law is inadequate

Venezuela's insolvency law is very old and can be found in its Commercial Code. The law provides for two types of proceedings: bankruptcy and moratorium. Bankruptcy applies when the debtor's assets, if liquidated, would not be sufficient to satisfy all liabilities. This proceeding is essentially akin to a liquidation. The moratorium procedure applies when the debtor's assets, when liquidated, would be sufficient to satisfy all its liabilities. The moratorium lasts no more than a year, unless creditors representing 50 per cent of the debt approve an extension. In theory, this proceeding is more like a restructuring in that it allows the debtor to continue to

manage the business and to enter into agreements with creditors. Any such agreement requires the approval of creditors representing at least three-quarters of the debtor's debts.

However, in practice, the moratorium is often not available to troubled companies because of the requirement that the debtor is solvent; this results in the debtor losing control of its assets to a receiver and the court. While the reasons for this are varied, some experts opine that the law was not meant to address the restructuring of a complex financial capital structure, as evidenced by the lack of a dedicated bankruptcy court or bankruptcy judges to oversee moratorium proceedings. Thus, Venezuelan companies typically prefer to negotiate with creditors privately.

If the options described below proved unavailable to a Venezuelan company needing to restructure US-dollar-denominated debt and the company resorted to using a moratorium proceeding in Venezuela, then it could seek to bolster the local filing with a filing under Chapter 15 of the US Bankruptcy Code. Under Chapter 15, a debtor seeks a US bankruptcy court's recognition of a foreign bankruptcy proceeding, which has the effect of staying litigation against the debtor in the US, including any litigation that could be commenced by one or more bondholders. A Chapter 15 case would also permit the debtor to seek to have a US bankruptcy court recognise any orders or judgments that are entered in a moratorium proceeding, including the approval of any agreement between the debtors and its creditors. A number of Latin American companies have been able to successfully use Chapter 15 to supplement their insolvency filings under local law.

The 2014 Chapter 15 case of Brazilian electric power company, Rede Energia SA (Rede), is a recent example. Rede sought assistance in enforcing its Brazilian plan of reorganisation. The plan offered bondholders, who were owed $496 million in US-dollar-denominated notes, a 25 per cent recovery. Over the objection of several bondholders, the US Bankruptcy Court for the Southern District of New York enforced and recognised the Brazilian plan, and enjoined further litigation by such bondholders in the US.

Voluntary exchange offer

This option involves a voluntary, private exchange offer by a debtor's bondholders to one or more new securities. This option has the advantage of avoiding the cost and uncertainty that could be associated with a court proceeding. However, this option is not without its own set of disadvantages and risks. Most importantly, because, as the name suggests, the exchange offer is voluntary, it is often difficult to achieve a fully successful restructuring absent support from an overwhelming percentage of bondholders. And this result can become more complicated if the debt has traded hands to non-par holders who may possess a different investment objective than a par holder and decide to "holdout" from the exchange offer. As such, many exchange offers, in order to address these issues, are coupled with the option to utilise Chapter 11 of the US Bankruptcy Code.

Chapter 11 of the United States Bankruptcy Code

In situations where a debtor believes that an exchange offer is unlikely to result in a successful restructuring, several companies, including companies in Latin America, have utilised Chapter 11 to effect a restructuring of US-dollar denominated debt.

The US Bankruptcy Code provides that "a person that resides or has a domicile, a place of business, or property in the US... may be a debtor under this title." This language has been interpreted broadly by US bankruptcy courts, and the presence of a bank account in the United States has been deemed sufficient for a foreign company to qualify to commence a bankruptcy case under Chapter 11. Chapter 11 provides a debtor with a number of tools designed to increase the likelihood of a successful restructuring, including the stay of actions against the debtor or its property, the ability to obtain financing while in bankruptcy, as well as the ability to effect a restructuring plan to address the debtor's US-dollar-denominated debt. This option, however, can become costly the longer that the debtor is required to remain in bankruptcy, and thus it is more common for foreign debtors to avail themselves of Chapter 11 when they have sufficient support from their creditors that will allow such debtors to utilise Chapter 11 as part of a "pre-packaged" or "pre-negotiated" plan of reorganisation.

"Pre-packaged" or "pre-negotiated" plan under Chapter 11

A pre-packaged or pre-negotiated option would entail presenting bondholders with an exchange offer much like the one described above. However, the offer would be supplemented with a plan of reorganisation and bankruptcy ballot such that if the debtor does not achieve a certain percentage participation rate in the exchange offer, it can implement the exchange through a Chapter 11 plan of reorganisation. In contrast to the high participation thresholds in a typical exchange offer, under Chapter 11, the plan would only require the approval of half the number of creditors representing two-thirds the value of the debt (of those actually voting) in order to be accepted and confirmed.

This option is also speedier than a traditional Chapter 11 plan; a pre-packaged bankruptcy can be completed within 45 to 70 days of filing. This is because a pre-packaged plan allows a debtor to have the plan already in place and presented to bondholders prior to the bankruptcy filing. A pre-packaged plan option also provides a debtor with greater certainty than a traditional bankruptcy case, because the debtor will already have votes in favour of the plan that satisfy the voting requirements before it ever decides to file for bankruptcy.

This option was recently utilised by the Chilean company, Inversiones Alsacia and Express de Santiago Uno (Alsacia). Alsacia is one of the largest bus companies operating in the Santiago, Chile metro system. Facing lower-than-expected cash flows and looming interest payments, Alsacia restructured bonds worth $464 million through a debt-for-debt exchange and pre-packaged plan of reorganisation, whereby holders of the company's 8 per cent senior secured notes due in 2018 received new notes equal to the original face value plus accrued and unpaid interest. Other bondholders received cash distributions.

Alsacia first presented the plan to bondholders in September 2014. On 16 October 2014, Alsacia filed for bankruptcy under Chapter 11 in the US Bankruptcy Court for the Southern District of New York. It filed its plan of reorganisation that same day and had the plan confirmed less than two months later, on 4 December 2014.

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