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New Bribery Suit's Implications For Venezuela Restructuring

By **Richard Cooper and Boaz Morag** (March 19, 2018, 1:42 PM EDT)

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Lawyers recently unsealed a complaint filed in the United States District Court for the Southern District of Florida on behalf of Venezuela's state-owned oil company, Petróleos de Venezuela SA, or PDVSA, against a group of 44 oil trading companies, banks and individuals. The suit alleges that the defendants participated in a 14-year scheme to rig bids, underpay on purchases, and overcharge on sales, allegedly resulting in billions of dollars of losses to PDVSA.

According to published reports and the amended complaint in the suit, an entity called the PDVSA US Litigation Trust was formed in New York on July 27, 2017, to investigate and pursue potential claims by PDVSA against third parties.[1] According to the trust's counsel, PDVSA irrevocably assigned to the trust any claims PDVSA has for bribery, bid rigging, price fixing and the like, which the trust is now bringing on behalf of PDVSA itself. Counsel to the trust maintains that the trust, rather than PDVSA, controls the litigation, but that PDVSA will receive the benefits of any recovery, after deducting the contingency interest of the trust's counsel, once U.S. sanctions that currently block "dividend payments and other distributions of profits"[2] to PDVSA are lifted.

The decision by PDVSA to pursue these claims in the United States at this time via a litigation trust raises a number of interesting legal and strategic issues not just for the defendants named in the suit, but also for PDVSA's bondholders and potentially other creditors, including creditors of the republic.

Published reports and the court filings suggest that one reason the trust structure was adopted was to prevent future PDVSA management from interfering with or shutting down the litigation. The trust structure may also have been motivated by an interest in shielding the claims owned by the trust from any future recoveries that financial creditors of PDVSA might obtain. Until now, those financial creditors were facing the prospect of pursuing claims to billions of dollars in defaulted PDVSA bonds without any known PDVSA assets in the United States, other than PDVSA's indirect interest in Citgo Petroleum Corp.[3] The success of the trust in recovering the billions in damages it is claiming on PDVSA's behalf could significantly alter the enforcement picture for PDVSA bondholders (and even republic of Venezuela creditors claiming PDVSA is the alter ego of the republic) in the United States.

Thinking beyond the current Venezuelan regime and ahead to what a future restructuring scenario

might look like, it also could provide the proverbial carrot to offer creditors willing to restructure their claims as part of a global restructuring of the debt of PDVSA, and possibly even the republic.

The Suit

For years, PDVSA has been plagued by mismanagement and allegations of corruption. Following a major strike of PDVSA employees in 2002, then President Hugo Chavez fired two-thirds of the company's management and technical staff. With less experienced Chavez loyalists taking the place of prior management, PDVSA's strategy became increasingly politically motivated.[4] Since then, the company has experienced a number of scandals.[5] Though stories of corruption inside PDVSA are nothing new, the trust's recent allegations are perhaps the most far-reaching, implicating some of the largest oil traders in the world in addition to former PDVSA insiders.

The trust alleges that starting in 2004, two Venezuelan nationals, Francisco Morillo and Leonardo Baquero, hatched a plot to bribe PDVSA employees in order to obtain PDVSA's confidential commercial information and sell that inside information to oil traders. Morillo and Baquero allegedly entered into illicit agreements with managers in PDVSA's commercial departments to pay those employees bribes in exchange for advance confidential information concerning PDVSA's future tenders for sales of heavy oil that PDVSA produced and purchases of light crude and additives PDVSA required for its refining operations.

The bribes were allegedly facilitated with the knowledge and approval of numerous multinational oil trading companies. The complaint names Lukoil, Colonial Oil, Glencore, Masefield, Trafigura and Vitol as participants in the scheme. These traders, over the years, have purchased significant volumes of PDVSA's heavy crude and sold PDVSA considerable quantities of light crude and additives, and indeed, some continue to do so today.

According to the complaint, Morillo and Baquero would transfer PDVSA's inside information to these oil traders, who would then instruct Morillo and Baquero on how to rig selected future tenders so as to ensure either that the traders would win those contracts by being the only bidders able to fulfill the specific terms of the tender, or that their bids would beat the bids of competing oil traders. The complaint alleges that Morillo and Baquero would relay the instructions to the bribed employees at PDVSA, who would modify the future tenders accordingly. By manipulating the tenders in this way, the oil traders were allegedly able to bid below market value and still secure contracts. The trust alleges that the bid-rigging scheme reduced or eliminated competition in the market, which caused PDVSA to sell its products at artificially low prices and to buy products at artificially high prices, resulting in billions of dollars of losses to PDVSA.

Morillo and Baquero also allegedly obtained confidential information through the use of a "clone server," which they installed in or around 2005 with the assistance of one of the bribed PDVSA employees. The clone server allowed them immediate access into PDVSA's computer systems, providing insight to the real-time bids submitted by competing oil traders for tenders already released by PDVSA for bidding, in addition to information on future tender contracts. The oil trader defendants allegedly used this information to outbid their competitors and secure their desired contracts.

In addition to the bid-rigging scheme, the suit claims that Morillo and Baquero also orchestrated a scheme by which PDVSA would be underpaid for products it sold, and was underdelivered on goods it purchased. The allegedly bribed employees would cause PDVSA to pay the oil traders upfront on a purchase agreement and then accept delivery of less than the full amount of the purchased product,

and likewise accept less than full payment for the sale of PDVSA's oil. The trust alleges that these underpayments to, and overpayments by, PDVSA totaled in the billions of dollars.

In addition to Morillo and Baquero and the oil trader defendants, the complaint names a number of former PDVSA employees who allegedly accepted bribes, each of the shell companies allegedly used to launder bribe money, and a number of banks who allegedly facilitated transfers of bribe payments.[6]

The Claims

The complaint lays out a wide variety of U.S. federal and state law claims against the defendants stemming from the allegations above.

The trust alleges that all the defendants committed antitrust violations by colluding in a bribery scheme in order to gain an unfair competitive advantage over other market participants. Specifically, it alleges that the oil trader defendants entered into illegal agreements with Morillo and Baquero and related companies to obtain and exchange confidential information and reduce competition for PDVSA's products in order to artificially depress prices in violation the Sherman Act, the Robinson-Patman Act and related Florida antitrust laws. If the trust succeeds on its Sherman Act antitrust claims, the defendants would be liable for treble damages and the costs of the suit, including attorneys' fees.

The trust also alleges that the defendants violated the Racketeering Influenced and Corrupt Practices Act, or RICO, and related state laws by engaging in a pattern of criminal activity with the common goal of defrauding PDVSA. The trust alleges that the defendants all participated in a racketeering scheme that involved, among other things, bribery, mail fraud and money laundering. Notably, a federal civil RICO claim requires that the plaintiff allege and prove a domestic injury to business or property.[7] The trust alleges that the defendants' activity "caused PDVSA to suffer direct damages and losses from PDVSA's U.S. bank accounts." Whether or not this allegation is sufficient to satisfy the requirements of a domestic RICO injury and what the extent of losses were to any PDVSA U.S. bank accounts are uncertain. If the trust succeeds on its RICO claims, however, the defendants would be liable for treble damages and the costs of suit, including attorneys' fees.

The trust alleges a host of other related federal, state and common law claims, including violations of the Stored Communications Act, the Computer Fraud and Abuse Act, federal Wiretap Act and Florida Uniform Trade Secrets Act, the last of which provides for recovery of double damages.[8] The trust is also seeking punitive damages as well as injunctive relief on the majority of its claims.

On the same day as it commenced the action, the trust also filed an ex parte motion for a temporary restraining order, preliminary injunction and delayed service. The motion sought an order to immediately seize electronic records that contain information allegedly stolen from PDVSA in the possession or control of the Florida defendants (including Morillo and defendants alleged to be associated with him), freeze those defendants' assets, and restrain those defendants from destroying records relating to their business or to PDVSA. On March 5, 2018, after a hearing, the court denied the portions of the motion seeking a temporary restraining order to seize defendants' information and freeze their assets, but granted the motion directing defendants to preserve evidence.[9] The court found that the trust had "failed to provide sufficient specificity to warrant" a seizure of all electronic records and devices of the Florida defendants from six different locations in Miami. As to the asset freeze, the court ruled that such relief was unwarranted where the assets to be seized were not PDVSA's money "either fraudulently obtained or withheld," but rather alleged "payments made by third parties to the Morillo Group Defendants in furtherance of a scheme to defraud" PDVSA.[10]

The Issues

On its face, the complaint presents a number of interesting legal questions.

Standing

Because the complaint only alleges harm done to PDVSA, there is a question about whether or not the trust has standing to litigate the claims. As noted above, the trust's counsel has stated that PDVSA irrevocably assigned the trust its litigation rights in this matter, but the complaint does not provide the details of any such transfer. The transfer may raise questions about who at PDVSA authorized it, whether it was validly approved, what the consideration was for the assignment, and whether the decisions of the trust (or any trustee acting on its behalf) are truly free from PDVSA influence (Could the trust settle all claims, for example, for an amount that provides a de minimis recovery for PDVSA?). The complaint is also silent as to which individuals control the trust, how they were selected, and what the scope of their powers are to direct the trust's counsel. These issues will no doubt attract the interest of the defendants named in the complaint, but they also may raise concerns in the minds of PDVSA creditors (and even republic creditors) who see these potential claims — and the assignment of them to this trust at a time shortly before Venezuela announced that PDSVA and the republic would need to restructure — as a possible source of recovery in a future enforcement action against PDVSA or even in a consensual restructuring transaction.

Statute of Limitations

The statute of limitations for civil RICO and the Sherman Act claims is four years. The complaint alleges illicit activities that started as early as 2002, yet it was not filed until 2018. The defendants will no doubt question when PDVSA was put on notice of suspicions necessitating an investigation into the facts. The complaint pleads that the limitations period in this case was tolled by the fraudulent concealment of the scheme, in that PDVSA employees who were allegedly bribed also actively and intentionally concealed material facts to ensure that the scheme was not discovered by PDVSA management. Whether the trust can satisfy the heightened pleading requirements associated with asserting fraudulent concealment, so as to render the complaint timely, is a potentially significant issue.

Cooperation from PDVSA

Notwithstanding PDVSA's purported assignment of the claims to the trust, the defendants will likely insist that the trust produce in discovery all the documents and witnesses PDVSA would be required to produce had it pursued the claims directly. To comply, the trust must either already have obtained a tremendous volume of information and electronically stored data from PDVSA and secured the cooperation of key witnesses, or it will need PDVSA's complete cooperation going forward. If PDVSA refuses (or makes it impractical) to respond to the numerous discovery and other requests that undoubtedly will be generated by this litigation, it could have significant adverse consequences for the trust's ability to effectively pursue its claims or maximize its leverage in any settlement discussions.[11]

Attachment Risk

The trust is pursuing causes of action it contends are worth billions of dollars. Moreover, if successful, the trust will be the recipient of substantial sums that it will be holding for the benefit of PDVSA. In the past, sovereign creditors have sought to attach commercial claims being pursued by a sovereign debtor

against a third party as well as funds in the hands of a trustee held for the benefit of the sovereign.[12] The filing of the complaint may well lead PDVSA's bond and other commercial creditors to take action either now or as the litigation progresses to seek to lay claim to the economic value of the trust's lawsuit or to any recoveries on the theory that the Trust is pursuing the claims for PDVSA's sole benefit and, after deducting legal fees and other expenses, PDVSA has the right to receive all remaining recoveries.[13] The trust's legal status as allegedly separate from PDVSA may not shield its claims or recoveries from attack by creditors of PDVSA, as it is not likely that the trust purchased the claims for fair value and its counsel has acknowledged that PDVSA will have a right to receive the net proceeds.[14]

Sanctions

It appears that the trust was formed (and presumably the PDVSA claims assigned to it) before the president issued Executive Order 13808 on Aug. 24, 2017, imposing limited sanctions on entities owned or controlled by the government of Venezuela; in any event, nothing in the executive order prohibits the assignment of these claims. The trust's counsel suggested in an interview that any funds recovered by the trust would be subject to sanctions blocking the payment of "dividends and other distributions of profits" to PDVSA from any entity owned or controlled, directly or indirectly, by the government of Venezuela. However, it is not self-evident that distributions from the trust would constitute "profits" or "dividends," particularly in light of clarification from the Office of Foreign Assets Control that the terms were meant to be construed literally and to exclude distributions to the government of Venezuela, such as taxes, royalties, payment for goods or services, and principal or interest.[15] It is therefore possible that any amounts realized by the trust could be distributable to PDVSA prior to the lifting of sanctions. Should PDVSA become subject to blocking sanctions, its contingent interest in the trust is probably sufficient that the trust itself would also be blocked and unable to proceed without OFAC licensing.

Implications and Conclusions

Though still in the early stages, this lawsuit could have significant consequences for PDVSA and for PDVSA bondholders and other creditors, including possibly republic creditors who are seeking (or may seek) to hold PDVSA liable for obligations of the republic.

Despite defaulting on billions of bond debt, neither PDVSA nor the republic has seen any of its bond debt accelerated or any bond trustee or individual bondholder (in the case of republic bond debt) sue for missed interest or principal payments. Will the commencement of this litigation change that? The answer to that may be clearer after we learn more about the case and the details around the creation and control of the trust.

Right now, creditors have been reluctant to pursue enforcement efforts because the costs and risks of initiating an enforcement action seem to outweigh the benefits of obtaining a judgment against PDVSA. On the benefits side, the principal benefit to a PDVSA or republic bondholder of taking action is positioning oneself (or the trustee in the case of PDSVA) to get to the proverbial courthouse door before others find their way there. Being a first mover in terms of enforcement could potentially provide litigating bondholders leverage in any future negotiation and access to information about the location of PDVSA assets against which to seek to recover (aside from Citgo and its holding companies).

In the case of the republic, obtaining a New York money judgment could also insulate a bondholder from the risk of being forced to accept a restructuring against its will through the use of the collective action provisions contained in most (but not all) republic bonds. While potentially helpful, these benefits have

to be weighed against the costs and risks of pursuing an aggressive litigation strategy at a time when neither PDVSA nor the republic is in a position to settle such claims or restructure its debt (given U.S. sanctions and the policies and nature of the current Venezuelan regime) and recovering on any judgment will be challenging. Litigation is time-consuming and expensive and, for PDVSA bondholders, any such litigation would require that they work through (and fully indemnify) a trustee who will require full indemnity and likely a substantial escrow. Any recovery would have to be shared with other holders on a pro rata basis and they would not be able to fully control the litigation or any settlement therefrom given the nature of PDVSA's bond indentures.

An enforcement campaign aimed at PDVSA could also precipitate other adverse actions that may be value-destructive — actions by PDVSA's secured bondholders to seize a controlling interest in Citgo, PDVSA's most valuable asset outside of Venezuela, or even further U.S. sanctions.

Finally, pursuing an acceleration and obtaining a judgment could, on a relative basis, actually reduce the claims that such holders would otherwise be entitled to under their respective bond documents given that post-judgment interest would accrue at a lower rate under applicable federal rules then it would under the contracted rate of most PDVSA bond documents. Stated differently, if one assumes that no restructuring can take place until the current government of Venezuela is out of power and that any restructuring will take years to effect given the challenges Venezuela faces, holders that accelerate and obtain a judgment in the near term will accrue interest at a much lower rate than the claims of other PDVSA bondholders that have not taken such action, and thus, such holders may be doing more harm than good by initiating an action precipitously.

Although it is impossible to know today whether the existence of the trust will change the calculus that many PDVSA bondholders (and perhaps even some republic bondholders) are considering, it is at least possible that as the trust's action proceeds, certain bondholders may see the potential ability to attach the "rights" the trust purportedly has in these claims as a sufficient inducement to commence actions against PDVSA and position themselves as the first beneficiaries of those recoveries.

Whether or not the calculus for initiating enforcement action against PDVSA changes as a result of the trust's pursuit of these claims, if the trust is actually able to recover against the named defendants in amounts anywhere near the damages they are seeking (even before doubling or trebling), the course of Venezuela's restructuring will certainly change, both for PDVSA and the republic. We have long been of the view that a successful restructuring of both PDVSA's and the republic's debt will require a mix of carrots and sticks in order to overcome the significant challenges such a restructuring will entail.[16] One of the potential "carrots" that could be offered to creditors, mentioned in this article, was an interest in a "creditor-owned trust" that could be structured to insulate the assets of the creditor trust from the reach of disaffected creditors who had not consented to a restructuring. The thought was that this creditor trust could be capitalized with the debt tendered by consenting holders as well as other "assets" with value. The rights to the recoveries being sought by the trust could be one of those types of "assets" placed in the creditor trust, and there is no reason why, if real and ultimately proved to be valuable, those rights couldn't be used as part of the inducement to creditors of both PDVSA and the republic (which is PDVSA's largest creditor) to participate in a restructuring. New instruments of this creditor trust could be included in the package of securities offered to creditors and could supplement the recoveries of participating creditors. Though a long way off, one could easily see the architects of Venezuela's future restructuring using the potential recoveries from the trust as a means to facilitate what will certainly be one of the most complex sovereign restructurings of all time.

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[1] There are no publicly available filings made by the trust that the authors could find. In New York, the formation of a trust would not entail any public filings.

[2] Executive Order 13808, § 1(a)(iv), 82 Fed Reg. 41155 (Aug. 29, 2017).

[3] As discussed in our prior article, Venezuela's Imminent Restructuring and the Role Alter Ego Claims May Play in this Chavismo Saga, PDVSA's interest in Citgo is already the subject of enforcement efforts by Crystallex International Corp. and ConocoPhillips Inc., creditors of the republic of Venezuela holding awards or judgments in excess of $1.4 billion that are currently litigating whether PDVSA is the alter ego and liable for the debts of the republic.

[4] See Oil's Dark Secret, The Economist (Aug 10, 2006).

[5] See Marianna Parraga, Daniel Wallis, Special Report: Pension Scandal Shakes Up Venezuelan Oil Giant, Reuters (Aug. 11, 2011) (describing a number of scandals involving PDVSA, including one in which nearly half a billion dollars of PDVSA pension funds were lost after being invested in what turned out to be a Madoff-style Ponzi scheme run by a U.S. financial adviser who was closely linked to President Hugo Chavez's government).

[6] Two people associated with Morillo and Baquero were reportedly arrested by Swiss prosecutors in Geneva following a criminal investigation into one of the consulting firms set up by Morillo and Baquero, which allegedly served as a conduit for the payment of bribes. See Joshua Goodman, AP Newsbreak: Swiss Arrest 2 in Alleged Oil Corruption Case, NY Times (Mar. 12, 2018).

[7] See RJR Nabisco Inc. et al v. European Community et al., 136 S. Ct. 2090, 2111 (2016) ("Section 1964(c) requires a civil RICO plaintiff to allege and prove a domestic injury to business or property and does not allow recovery for foreign injuries.").

[8] The complaint also includes common law claims for breach of contract, fraud, civil conspiracy, aiding and abetting breach of fiduciary duty, unjust enrichment, and aiding and abetting fraud brought against only the bank defendants.

[9] Temporary Restraining Order, PDVSA US Litigation Trust v. Lukoil Pan Americas LLC et al., Case No. 17-20818-CIV (S.D. Fla. Mar. 5, 2018) (D.I. 9).

[10] Id., at 3.

[11] "[T]he assignee of a claim in litigation has a duty to obtain and produce the same documents and information to which the opposing parties would have been entitled had the assignors brought the claim themselves. 'It would be unfair to the defendants to permit plaintiff and the assignees to divorce the

benefits of the claims from the obligations that come with the right to assert them.'" Royal Park Invs. SA/NV v. Deutsche Bank Nat'l Trust Co., 314 F.R.D. 341, 347 (S.D.N.Y. 2016) (quoting JPMorgan Chase Bank v. Winnick, 228 F.R.D. 505, 507 (S.D.N.Y. 2005)).

[12] See e.g., Brant Point Ltd. v. The Republic of Congo, Case No. 0004238/2004 (N.Y.S. 2006) (denying a creditor's motion to execute upon the debtor's cause of action because the potential damages were protected under the Foreign Sovereign Immunities Act). PDVSA's potential damages in this case would almost certainly not be protected by the FSIA, and thus may be subject to attachment.

[13] In New York, a "debt against which a money judgment may be enforced ... may consist of a cause of action which could be assigned or transferred accruing within or without the state." N.Y. CPLR § 5201(a); Holbern Oil Trading Ltd. v. Interpetrol Bermuda Ltd., 658 F. Supp. 1205, 1208 (S.D.N.Y. 1987) ("Courts have held that creditors or judgment creditors of a party to an action may intervene to assert a lien on any proceeds or to claim their share of the proceeds of the action"); Marshak v. Green, 746 F. 2d 927, 931 (2d Cir. 1984) (Section 5201 "permits enforcement of a money judgment against any property which could be assigned or transferred, whether or not it is vested").

[14] Though typically a creditor can only intervene in a suit where the debtor is a party, courts have allowed creditors to intervene in suits where the debtor itself is not a party where the creditor has a "sufficiently direct interest" in the proceeding to entitle them to intervene. Holbern Oil Trading Ltd. v. Interpetrol Bermuda Ltd., 658 F. Supp. 1205, 1209 (S.D.N.Y. 1987) (granting intervention as of right to a judgment creditor where the judgment debtor was a subsidiary of the party to the action, the debtor's only assets were claims against the party, and the party's only assets were the claims it was pursuing against others).

[15] Office of Foreign Assets Control ("OFAC"), FAQ 527 (Oct. 3, 2017), available here (sanctions intended to capture "net income after taxes. For a business, this is generally total sales minus total costs and expenses.").

[16] Richard J. Cooper and Mark A. Walker, Venezuela's Restructuring: A Realistic Framework, Harvard Bankruptcy Roundtable (Sep. 21, 2017). Mark Walker is the managing director and head of sovereign advisory at Millstein & Co. LP.