New York Court of Appeals clarifies UCC Article 8 choice of law rules for validity of securities

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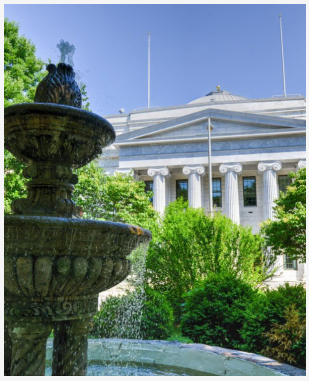

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On February 20, 2024, the New York State Court of Appeals (the Court) issued a ruling clarifying an important choice of law rule under the New York Uniform Commercial Code (the NYUCC). In *Petróleos de Venezuela S.A. v. MUFG Union Bank, N.A.*,[1] the Court interpreted for the first time the meaning of the "validity" of a security as used in NYUCC section 8-110(a)(1). The Court held that Venezuelan law governs the validity of certain secured notes issued by Petróleos de Venezuela, S.A. (PDVSA), Venezuela's state oil company wholly owned by the government of Venezuela, pursuant to an indenture governed by New York law (the indenture).

The decision provides clarity for bond and note holders, especially with respect to bonds and notes issued by sovereign entities. This article discusses the Court's decision and the implications under the Uniform Commercial Code and provincial *Securities Transfer Acts* in Canada.

Factual background

The exchange offer

Between 2007 and 2011, PDVSA issued notes maturing in 2017 (the 2017 notes). In 2016, the board of directors of PDVSA approved a bond exchange (the exchange offer) whereby holders of 2017 notes could tender their 2017 notes in exchange for new notes maturing in 2020 (the 2020 notes). Credit support for the 2020 notes was provided by way of (i) a guarantee from PDVSA Petróleo S.A. (Petróleo), a Venezuelan wholly owned subsidiary of PDVSA and (ii) a pledge by PDV Holding, Inc. (together with PDVSA and Petróleo, the PDVSA entities), a Delaware corporation wholly owned by PDVSA, of 50.1% of its equity interest in CITGO Holding, Inc. (the CITGO pledge), which in turn owns CITGO Petroleum Corporation, a refiner and petroleum products marketer in the United States.

The boards of each of the PDVSA entities approved the exchange offer in accordance with each PDVSA entity's applicable corporate formalities (including, in PDVSA's case, sole shareholder approval by the Venezuelan government).

The exchange offer closed and PDVSA issued the 2020 notes on October 28, 2016. The key

documents in connection with the issuance were the indenture, the 2020 notes themselves and a pledge and security agreement governing the CITGO pledge (the pledge agreement and, together with the indenture and the 2020 notes, the governing documents), each of which contained an express choice of New York law clause. MUFG Union Bank, N.A. was the trustee, and GLAS Americas LLC was the collateral agent, for the 2020 notes (collectively, the creditors).

The Venezuelan political backdrop

The exchange offer took place while intense political disputes were unfolding in Venezuela. Political parties opposing President Maduro controlled a majority in the Venezuelan National Assembly and opposed Maduro's and PDVSA's actions in connection with the exchange offer. In early May 2016, Maduro claimed by emergency decree the right to execute "public interest contracts" unilaterally, without approval of the National Assembly. In response, the National Assembly passed a resolution rejecting such decree on the bases of two provisions of the Venezuelan Constitution.

After the exchange offer was announced, the National Assembly passed a second resolution which, among other things, rejected the CITGO pledge. However, as noted, PDVSA closed the exchange offer notwithstanding the National Assembly resolutions.

After Venezuela's 2018 presidential election, the National Assembly named National Assembly President Juan Guaidó as the Interim President despite Maduro's claim to electoral victory. Interim President Guaidó appointed a new *ad hoc* board of PDVSA, which in turn appointed new boards for the other PDVSA entities. In October 2019, a third National Assembly resolution purported to ratify that the indenture violated the Venezuelan Constitution.

Background litigation

Following non-payment of a scheduled October 2019 principal and interest payment by PDVSA on the 2020 notes, the *ad hoc* board commenced litigation in the United States District Court for the Southern District of New York. The PDVSA Entities sought (i) declarations that the 2020 notes, indenture and pledge agreement are invalid, illegal, null and void *ab initio* and therefore unenforceable and (ii) an injunction restraining the creditors from enforcing any claimed remedy under the 2020 notes.

The District Court applied a traditional center-of-gravity conflicts analysis to conclude that New York law applied to the validity of the exchange offer. In turn, the District Court (i) declared that the governing documents were enforceable, the PDVSA entities were in default and the creditors were entitled to exercise remedies and (ii) entered a monetary judgment in favour of the creditors.

The PDVSA entities appealed to the United States Court of Appeals for the Second Circuit challenging the District Court's rulings on the choice of law issue. Noting that whether the parties' contractual choice of New York law overrides section 8-110(a)(1) of the NYUCC remains an open question under New York law and the absence of any cases applying the statute, the Second Circuit deferred deciding the appeal and instead certified the section 8-110(a)(1) question to the Court.

The Court's decision

The Court considered the question to be whether, given the presence of New York choice of law clauses in the governing documents, section 8-110(a)(1) of the NYUCC, which provides that the "validity" of securities in determined by the local law of the issuer's jurisdiction, requires the application of Venezuelan law to determine whether the 2020 notes were invalid due to a defect in the process for issuance of such securities (i.e., the contravention of constitutional provisions requiring National Assembly approval for issuance).

Section 8-110(a)(1) provides that "[t]he local law of the issuer's jurisdiction, as specified in subsection [8-110(d)], governs … the validity of a security." The term "validity" is not defined in the NYUCC. Section 8-110(d) provides that "issuer's jurisdiction" means "the jurisdiction under which the issuer of the security is organized or, if permitted by the law of that jurisdiction, the law of another jurisdiction specified by the issuer."

The Court noted that under New York contract law, the inclusion of a New York choice of law clause demonstrates the parties' intent that a court not conduct a conflict of laws analysis unless the parties or the legislature clearly express a contrary intent. Since the parties chose New York law, pursuant to General Obligations Law (GOL) section 5-1401(1), the governing documents were governed by New York's substantive law unless any of the narrow exceptions set out therein applied. One such exception is that chosen New York law will not apply to the extent provided to the contrary in section 1-301(c) of the NYUCC. That section provides that if section 8-110 specifies the applicable law, that provision governs and a contrary agreement is effective only to the extent permitted by the law specified (i.e., Venezuelan law as the law of PDVSA's jurisdiction).

The Court cited the official comments to the UCC, which clarify that section 8-110's mandatory rule for validity was proscribed because the question of whether an issuer can assert the defense of invalidity may implicate significant policies of the issuer's jurisdiction of incorporation. The legislative history of the rule also confirms that exempting the validity of securities from New York's otherwise broad endorsement in GOL section 5-1401(1) of party choice of law was made to accord with the prevailing view that the issuer's jurisdiction's law must govern validity in the sense of having been issued pursuant to appropriate corporate or other similar action.

Turning to the meaning of "validity" under section 8-110(a)(1), the Court held that the term requires analysis of the related provisions of the Venezuelan Constitution because those provisions may govern the process by which the 2020 notes were "duly authorized." Without a definition of "validity" in the NYUCC, the Court looked to the prevailing understanding of the term in commercial and corporate law (i.e., due authorization by the issuer). Due authorization is understood to involve two issues, each of which is evaluated under the issuer's constitutive internal documents and the external law under which the issuer is organized:

1. Did the entity have the power to enter into the agreement?
2. Did the proper body or bodies within the entity approve the agreement in the manner required?

The Court was careful to distinguish validity from (i) enforceability and (ii) the consequences of validity or invalidity. Enforceability speaks to whether the contractual provisions are contrary to local law (e.g., usury restrictions on interest rates) whereas validity speaks to procedural requirements for due authorization (i.e., the process whereby the security comes into being in the first place). Additionally, chosen law still governs the consequences of

validity or invalidity. Therefore, since New York law generally governed the governing documents other than with respect to validity, even if the 2020 notes were invalid under Venezuelan law, the *effect* of that invalidity is nonetheless governed by New York law.

With that distinction in mind, the Court concluded that the constitutional provisions could potentially implicate validity of the 2020 notes because they speak to whether PDVSA had the power or authority to issue the 2020 notes and, relatedly, what procedures were required to exercise such authority. NYUCC section 8-202(b) further reinforced the Court's conclusion. That section provides that "[a] security ... issued with a defect going to its validity, is valid in the hands of a purchaser for value and without notice of the particular defect unless the defect involves a violation of a *constitutional provision*" (emphasis added), in which case "the security is valid in the hands of a purchaser for value and without notice of the defect, other than one who takes by original issue." Legislative history indicates that validity is not limited strictly to compliance with corporate formalities, but rather can also be determined by reference to a qualifying constitutional provision.

The Court therefore answered the certified question to the Second Circuit by concluding that section 8-110(a)(1) requires application of Venezuelan law (including, potentially, the Venezuelan constitutional provisions) to determine whether the 2020 notes were valid. The case now returns to the Second Circuit. However, it should be noted that the Second Circuit stated in its certification decision that in light of the Court's ruling it would likely remand to the District Court for an assessment of Venezuelan law regarding PDVSA's legal authority to execute the exchange offer.

Takeaways

Petróleos marks the first time the Court has considered the NYUCC's choice of law rule for validity of securities. Creditors and debtors transacting in debt securities can now take greater certainty under New York law as to which law will govern issues of validity of securities. In bond and note offerings, this is critically important given the bonds or notes are the principal instruments creating the debt. When an issuer is a traditional non-governmental entity, validity is often a relatively straightforward matter of ensuring compliance with corporate formalities such as board or shareholder approval. Legal opinions on such validity are often customarily obtained to provide further comfort to creditors. However, as *Petróleos* demonstrates, creditors of sovereign and governmental entities should take particular care to ensure that all applicable laws (including potential constitutional provisions) of the issuer's jurisdiction are complied with when issuing debt securities.

In Canada, provincial *Securities Transfer Acts* (STAs) modelled largely on Article 8 of the UCC have been adopted in each province. The STAs contain similar choice of law rules as Article 8. While we are not aware of any Canadian case law to date interpreting the STAs' choice of law rules for validity of securities, given the parallels between the STAs and Article 8, *Petróleos* would likely be instructive to a Canadian court facing similar issues. For instance, Ontario's *Securities Transfer Act, 2006* (the OSTA) contains the same choice of law rule for validity of a security: the issue is determined by the internal laws of the issuer's jurisdiction of incorporation or organization.[2] Unlike NYUCC section 8-110(d), though, the OSTA does not permit an issuer to specify a different jurisdiction as its "issuer's jurisdiction" for purposes of validity if permitted by the law of the issuer's jurisdiction of organization. Further, the OSTA also provides that if a defense or defect that goes to validity exists, the plaintiff has the burden of establishing that the defence or defect cannot be asserted.[3] These differences suggest an even greater deference under the OSTA to policies of an issuer's jurisdiction of organization relating to invalidity defenses.

In the case of a sovereign or governmental issuer like PDVSA, the OSTA expressly provides that a security is valid if issued in accordance with the issuer's jurisdiction's law and "the constating provisions governing the issuer."[4] A Canadian court could similarly interpret such provision as the Court in *Petróleos* did for NYUCC section 8-202(b) by holding that validity can also be determined by reference to constitutional provisions governing the issuer (e.g., Venezuela's Article 150 with respect to PDVSA). Therefore, bond and note creditors under Canadian law governed bond and note issuances should take care to verify that all applicable laws of the issuer's jurisdiction are complied with to ensure the securities' validity.

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[1] 2024 NY Slip Op 00851 available at: https://www.nycourts.gov/reporter/3dseries/2024/2024_00851.htm (*Petróleos*).

[2] S.O. 2006, c. 8, s. 44(1)5. Other rules apply for issuers incorporated under federal Canadian law and for the Crown in right of Canada or a province in Canada.

[3] OSTA, s. 53(5).

[4] OSTA, s. 2.