Part 3

Regulating International Investment

CHAPTER XVII

CAPITAL TRANSFERS

This chapter turns to a third major international economic flow-—that of capital. Its goal is to explain the various motivations for and forms of international investment. It also presents the macroeconomic regulations affecting that flow, particularly those associated with international bank loans. Later chapters will explore the protection of the individual investor, the regulation of the multinational firm, and the resolution of disputes between a multinational firm and its host nation.

A. LEGAL FORMS OF CAPITAL FLOW

Just as for a national capital market, there can he many possible forms and instruments for international capital flow. Among the most important legal forms (which are not directly correlated with the economic forms) are the following:

Bank loans to governments or individuals. These are loans made by the regular banking system, usually denominated in a hard currency, generally dollars, from banks to governments or individuals. In recent years, these have been granted for relatively short terms, but typically rolled over regularly. The International Bank for Reconstruction and Development (IBRD or World Bank) and the various regional development banks also make such loans. For the private banks, the counter-balancing deposits include those from OPEC treasuries as well as from domestic investors in the United States and Europe, and perhaps from developing nation elites investing a return flow of funds. This market is international, with the banks lending hinds to one another in what is usually called the "Eurodollar market," a market that grew from a few billion dollars in the mid l960s to over $600 billion around 1980. Interest rates are usually defined in terms of points above LIBOR, the London interbank loan rate set as a market rate for these bank-to-bank loans.

Bond issues by governments or corporations. These are issues of long-term (10 to 30 years) generally fixed-rate securities by the more successful developing nations, by major corporations, and by international lending agencies such as the IBRD. The investors, whose identities are carefully concealed in the issue process, may include at least some OPEC interests and certainly include many developed-world institutional investors. These loans are typically made through syndicates of European investment banking houses.

Stock issues q/ corporations. These are the sale of equity interests in private corporations to an investor in a nation other than that of incorporation. They can take the form of "portfolio" investment, in which the investor gains no significant control over the corporation, a situation exemplified by a small investor's purchase of a few shares of stock in a foreign corporation. They can also take the form of "direct" investment, in which a corporation acquires a controlling interest in or substantial control of a foreign corporation, either through purchasing stock in a going concern or through creating a new corporation under local law as an affiliate or subsidiary.

International branch operation. This is the direct purchase of foreign assets, such as land or a factory. This is not economically different from creating a subsidiary to conduct the same operation, but is clearly legally different. A firm's choice of legal pattern depends on such factors as the tax benefits of foreign incorporation and the desire or not to place the home corporation's assets at risk in the foreign operation. In general, the foreign subsidiary's earnings are not taxable at home until they have been declared as dividends (a position quite logical in the legally similar case of portfolio investment), while the branch's earnings are immediately taxable at home. And while a firm will usually want to create a subsidiary to limit the parent corporation's liability, a bank may have to operate through a branch in order to create the confidence derived horn making its entire assets available for settlement of obligations arising within the host jurisdiction.

Some of the variations in the above reflect economic differences. Anyone studying the corporation is familiar with the spectrum of financing patterns beginning with bank loans and moving through bonds to equity investment, and the way the extent of economic control associated with the loan increases along that spectrum while the priority of payment obligations, both in bankruptcy and during the firm's ongoing existence, correspondingly decreases. And there are clear economic differences between loans to a nation's government and loans to a private (or semipublic) entity within that nation–loans that may create an economic allocation different from that which the government would have chosen.

The economic and the legal forms, however, fail to correspond in the case of branch and subsidiary investment, which are very different legally, but need not differ economically. When these investment forms bring control, they are economically indistinguishable from each other–and they are radically different economically from portfolio investment, which, almost by definition, does not bring control. Economically, the real question is whether the transnational operation is being operated as a single unit, something that can be achieved with either a branch or a subsidiary. The economics depends on management structure; under some management strategies local management may be given so much control (whether the local arrangement is that of branch or subsidiary) that the corporation is not operated as an entity anyway.

"Company law," as corporation law is known in most of the world, deserves very careful attention in any actual case. In most nonsocialist nations, company law permits a foreign corporation to create a wholly owned subsidiary. Formalities may require that a host country national sit on the board of directors or its analogue, or that token shares of stock be held locally, but control is usually achievable.

Nevertheless, there are surprises. Most nations define separate legal regimes for companies with few shareholders and for those with many shareholders. This corresponds to the U.S. distinction between close corporations and publicly held corporations. In Germany, for example, the publicly held corporation has several layers of management and boards, and also provides for employee participation (*Mitbestimmung*). Moreover, in many foreign states, shares are held in bearer fashion (typically through banks for physical safety) rather than there being a central registry, as is typical in the United States. This foreign approach reflects the investor's interest in privacy against the government, an interest reinforced by such historical examples as Nazi efforts to discriminate against Jewish shareholders. The approach also requires governments to use withholding to collect taxes on dividends.

Later chapters will explore techniques of direct investment and the legal disputes - arising from such investment. This chapter emphasizes bank lending, as exemplified by the credit agreement in the Selected Documents Supplement, which should be consulted at this point. This particular credit agreement is designed for a loan made by a group of banks, each of which funds a portion of the loan. The loan uses a variable interest rate, and it gives the borrower flexibility in deciding how much to borrow at any specific time. The following questions refer to this credit agreement.

QUESTIONS

1. How is the amount lent to be set? The interest rate? The share of each bank?
2. Do you think the provisions of Art. VIII of the credit agreement, assuring payment in dollars, should be legally enforceable? (You will want to reconsider this question after learning about the International Monetary Fund's (IMF's) Article VIII 8(2)(b) *(infra* at [redacted]) and after reading the *Weston Banking Corp*. case *(infra* at [redacted]).
3. Can you explain the division of issues between Arts. IX and X?
4. Should the sovereign immunity waiver of Art. XIV be held effective? What are the pro and con arguments?
5. Notice the Events of Default in Art. XI. How is the existence of default determined? By whom?
6. What is the effect of Art. XI(d)?
7. What law governs this agreement? What are the arguments for and against upholding the provisions?
8. Could a state's decision to suspend payments on a loan be considered an act of state, and therefore not controlled by the terms of the loan agreement? For background, see *Allied Bank, infra* at [redacted].

B. MACROREGULATION OF BANKING AND CAPITAL FLOWS

There is a special international legal structure dealing with the macroecnomic issues arising from portfolio and bank investment and from trade imbalances. This international monetary law helps assure that such capital flows–and economic restrictions to respond to them–distort trade as little as possible. Its key institution, the IMF, has also been focusing increasingly on ways to avoid or resolve loan defaults that might threaten the stability of the international banking system.

1. Public Law of the International Monetary System

An international monetary regime can he defined as a set of rules and institutions for the macroeconomic coordination of the various national economies for responding to the fact that the fiscal (government budget surplus or deficit) and monetary (interest-rate and monetary control operations) policies of different states interact, and the policy designed to influence one nation's economy may end up having a cross-effect on other states' economies. (These are the "Keynesian" issues discussed in Chapter 1.)

The old pre-Depression gold standard system is probably the simplest example. At that time, it was assumed that a state's currency had to be backed by gold. In many states, paper currency was a transferrable right to obtain a certain quantity of gold or silver from the national central bank. National law directed that the amount of currency in circulation bear a defined ratio to the amount of gold or silver in the central bank's coffers. International adjustment was then easy and automatic. Suppose a state ran a balance-of-payments deficit because it imported more than it exported. It would then have to settle this deficit in gold. This would require it to reduce the amount of currency in circulation, thus decreasing domestic prices and making its goods more competitive internationally. Ideally, equilibrium would be restored.

There is a question as to whether the gold standard ever actually worked like this oversimplified description. In any event, it was ended during the Depression, when states arbitrarily devalued their currencies (in terms of gold) in order to make their exports more competitive and to thus “export” unemployment. Of more fundamental importance, political expectations changed–automatic adjustment processes became no longer politically acceptable and it became necessary to allow governments to intervene in their economies in accordance with Keynesian theories.

Hence, the Bretton Woods system, created at the end of World War II, attempted both to give governments greater freedom to intervene in their economies and to avoid competitive devaluations, The central concept was to fix currency rates vis-à-vis one another by international agreement. An institution was created–the IMF–that would, by a weighted voting procedure, authorize changes in the agreed rates in the event of “fundamental disequilibrium.” This approach was intended to complement the new GATT system.[1] Ideally, if a state began falling behind others in employment levels, it would respond by changing its currency value rather than by imposing trade restrictions. Hence, free trade could be achieved while giving weaker economies a chance.

The obvious question was how currency values were to be maintained at a fixed relationship, even though governments might engage in inconsistent economic policies. The answer was through a duty of exchange market intervention. When its currency fell more than a defined percentage in comparison with others, a state was obliged to buy its currency and sell the foreign currencies in order to maintain the desired relationship. And a state whose currency rose above the margin was to sell that currency and buy others.

The practical limiting factor was the state’s store of foreign hard currency, a major component of its currency “reserves.” A creditor state could always print more of its own currency to sell to maintain the price relationship. But a debtor state had to buy its currency and sell foreign currency. Its reserves of foreign currency, therefore, determined how long it could defend a defined currency price. The IMF system provided a number of ways to increase these reserves or “international liquidity.” They all depended on the fact that dollars, say, were useful reserve assets when in U.K. hands, even though they were not in U.S. hands, Thus, a simple swap arrangement–mutual promises by the United States and the United Kingdom on demand to exchange so many billion dollars in returns for pounds or vice versa–could increase the effective foreign reserve assets of each.

Although swaps were widely used, the original and core method was a more formalized variant relying on the same logical principle. This was a “drawing”–the borrowing of foreign currency (in return for national currency) from a pool of currencies held by the IMF and deposited with that institution. Whenever a state became a member of the

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1. Of course, when the IMF Charter was being negotiated, the expectation was that a permanent International Trade Organization (ITO) would be established to coordinate macroregulation with the IMF., but the ITO was never approved by the United States and was indefinitely replaced by the GATT. For discussion of the GATT-as-institution, see Chapter III, *supra* at [redacted]-[redacted]. On the intended macroregulatory coordination among the Bretton Woods institutions, see Michael P. Malloy, *Shifting Paradigms: Institutional Roles in a Changing World*, 62 FORDHAM L. REV. 1911, 1918-1920 (1994).

IMF, it contributed a certain amount of its own currency, in proportion to an amount known as its “quota,” that determined voting and borrowing rights. It could later, as it needed to, draw foreign currency from the pool supplied by other member states. It naturally had to “repay” the “borrowing” over several years, and it also had to satisfy the IMF that its economic policies would help it do so–the “conditionality” requirement.

As a next step, the IMF created the Special Drawing Right (SDR), an even more abstract variant of the swap. SDRs are given a value defined in terms of a “basket” of currencies and are allocated to the member states in proportion to their quotas. Each member state is obliged to provide its own currency (up to a defined limit) in return for other states’ SDRs. Thus, looked at inversely, each SDR is a right to obtain a specified amount of any other member state’s currency, and therefore a useful reserve asset. As a right to obtain currency, the SDR is parallel to the old paper-money right to obtain gold and thus comes close to an international currency–although the SDR still takes the mechanical form of a centralized book of accounts rather than that of distributed pieces of paper.

The Bretton Woods system collapsed in the early 1970s, in a process described in part in the *Yoshida* case, Chapter III, *supra* at [redacted]. There were several reasons for the collapse. One was the perceived need to change the relative value of the dollar as the United States ran a long-term balance-of-payments deficit, deriving in part from the Vietnam War. Under the technicalities of the system, the United States could not do this alone, for other currencies were defined in terms of the dollar. The second reason was a series of exchange crises–as a state’s currency began to fall, speculators could estimate how long the government would be able to support it. At some point, a “run on the bank” would begin. Everyone would seek to sell the currency, and the state’s central bank would expend billions to keep up the value of its currency. Then the markets would close, and the IMF would authorize a new exchange rate. As the Eurodollar market grew along with international capital flows, these crises became more frequent and more severe.

The result was to give up the obligation to maintain fixed exchange rates and to shift to a system “floating” rates. This deprived the IMF of its traditional raison d’etre–but the institution remained in existence to help nations maintain the exchange rates they desired for economic purposes, to help the developed states coordinate economic policy, and to make loans to and provide economic supervision of debtor states. These roles are described more fully in the following excerpt.

J. GOLD, FINANCIAL ASSISTANCE BY THE INTERNATIONAL MONETARY FUND: LAW AND PRACTICE

IMF Pamphlet Series No. 27, 2d Edition (1980)

General Aspects

Articles of Agreement And Membership

The International Monetary Fund is an intergovernmental organization in which, on October 1, 1984, there were 148 members. Membership is confined to states that control their external relations and are able and willing to perform the obligations imposed on members by the Articles of Agreement. The Articles were drafted at the Bretton Woods Conference held in July 1944. The treaty has been amended twice.

Except as otherwise authorized by the Articles, the financial activities of’ the Fund are conducted between the Fund and a member through the medium of its treasury, central bank, stabilization fund, or other similar fiscal agency. The financial activities of the Fund are complex. The main activity is the Fund's financial assistance to a member in balance of payments difficulty by providing it with SDRs or the currencies of other members in support of an economic and financial program that is designed to overcome the difficulty. The Fund's financial, supervisory, and regulatory functions relate to the balance of payments. The Fund is concerned with other fields of economic activity, such as trade and development, but its jurisdiction to approve or disapprove measures stops at the borders of those fields. The Fund collaborates closely, however, with the organizations that have jurisdiction over these other activities.

In order that a member may use the Fund's resources, its economic and financial program must be consistent with the purposes of the Fund. A major purpose is the achievement of a multilateral system of payments and transfers for current international transactions in order to promote international trade and the benefits that flow from it. A multilateral system means the absence of exchange restrictions, multiple currency practices, and discriminatory currency arrangements. The idea is that, in international trade and in other current international transactions, residents and nonresidents should be as free to use currencies as they are to use a domestic currency within the domestic economy.

Resources of the Fund: Subscriptions . . .

The general resources, which will be referred to in the rest of this paper simply as resources, are derived mainly from subscriptions, loans, . . . and income. The subscriptions of members are the main source of the Fund's holdings in the first instance. Each member is assigned a quota expressed in SDRs, and its subscription is equal to its quota. In the past, 75 per cent of the normal original subscription of a member was payable in its currency and the rest was payable in gold. Under the Second Amendment, SDRs or the currencies of other members are substituted for the proportion formerly payable in gold, because, except in rare situations, gold is no longer used in obligatory payments to or by the Fund.

A member's quota is a fundamental datum in its relations with the Fund, governing or affecting, among other things, its voting power, the amount of SDRs it receives in allocations, and the amount of financial assistance it can obtain from the Fund. Both the absolute amount of a quota and its proportion of total quotas are important for members. This importance becomes painfully apparent when the adjustment of quotas is considered in the general reviews that must take place at intervals not longer than five years. The protracted and strenuous negotiations that take place on the adjustment of quotas can retard the necessary augmentation of the Fund's resources. An increase in quota gives rise to an obligation to pay an additional subscription equal to the increase. The further subscription is payable in proportions, prescribed by the Fund, in the member's own currency and in SDRs or the currencies of other members. The Fund's holdings of SDRs come from its receipt of them from members in its various financial activities. The Fund cannot allocate SDRs to itself on the occasion of an allocation to members or at any other time. . . .

Resources of the Fund: Borrowing

The second main source of the Fund's holdings is loans. The extent to which the Fund may borrow is unlimited in the sense that the Fund has full freedom to decide whether and how much to borrow. The Fund has authority to agree with a member that it shall lend its currency if the Fund deems it appropriate to replenish its holdings of the currency because it is needed for financing the Fund's transactions. The Fund also has authority to borrow a member's currency from other sources inside or outside the member's territories. No qualification is placed on the sources from which these borrowings may be made. The authority is wide enough, therefore, for the Fund to borrow from private lenders, including commercial banks. If, however, the Fund wishes to borrow the currency of a member from some source other than the member itself, the Fund must seek the concurrence of the member. The Articles insist on the necessity for concurrence in order to ensure that the Fund's entry into the capital market is not inconsistent with the member's management of its currency and does not interfere with the member's own ability to borrow. No member is required to lend to the Fund or to concur in loans of its currency to the Fund from other sources. . . .

Exchange Transactions

The Articles recognize that a member may make a purchase from the Fund under a stand-by or similar arrangement or without one of these arrangements, but in modern practice arrangements predominate except under certain special policies. A member may request a purchase if it has a need based on its balance of payments, or its reserve position (for example, uncomfortably low reserves), or unfavorable developments in its reserves (for example, an impending discharge of substantial indebtedness). The Fund may challenge a request for good cause, such as the absence of need, but the occasion does not arise because a member consults the Managing Director and the staff before submitting a request. A stand-by or similar arrangement makes this kind of consultation unnecessary before a purchase is initiated under the arrangement if the member is observing the terms of the arrangement.

When making a purchase, the member pays an equivalent amount in its own currency to the Fund. The transaction is never a loan according to legal analysis. The Articles rigorously avoid the language of loans and repayments and refer instead to purchases and repurchases. The closest analogy to the transaction of purchase and sale of currency between a member and the Fund is an exchange transaction in which a party buys foreign exchange from a commercial bank and pays for it with the domestic currency. The analogy is not exact. For example, the transaction with the Fund gives rise to an obligation resembling an obligation of reversal. The purchasing member must repurchase its own currency paid to the Fund in the transaction, but not necessarily with the same kinds of resources that it purchased.

The Fund pays remuneration, on the basis of a formula, to members whose currencies have been used in its transactions. Originally, the formula was based on the simple fact of the net use of the ideal. currency subscription of 75 per cent of quota, but the formula is now more sophisticated. The main source of revenue from which remuneration is paid is the periodic charges levied by the Fund on the holdings of currencies obtained from purchasing members in their transactions with the Fund.

Stand-By and Extended Arrangements

It has been seen that a member can request an immediate purchase of SDRs or currencies from the Fund. without having received a stand-by or extended arrangement, or it can. request an arrangement, which will give the member an assurance that it will be able to enter into transactions with the Fund should the need arise. The original concept of the stand-by arrangement placed more emphasis on its precautionary character, hut in more recent years most members requesting an arrangement have had an immediate need for resources. Precautionary arrangements continue to be approved, and in some circumstances a member has no realistic expectation that it will need to use the Fund's resources, but the member wishes to have testimony given to the world of its creditworthiness. The Fund has been willing to approve symbolic stand-by arrangements for this purpose. . . .

A stand-by (or extended) arrangement is approved by the Fund after negotiations between a mission composed of officials of the Fund's staff who act under the instructions of the Managing Director, and the member's representatives. The negotiations can be protracted, but need not be. From them, a "letter of intent" emerges, signed usually by the Minister of Finance or the Governor of the central bank, or by both, in which the intentions and policies of the member that constitute its program are set forth for the period of the arrangement. The Fund formulates the stand-by arrangement by reference to certain aspects of the letter of intent. The main purpose of this reference is to select those aspects of the program that are to be performance criteria and to ensure that the member will have access to the Fund's resources under the arrangement only if the performance criteria are being observed. The Managing Director submits the request and proposed stand-by arrangement to the Executive Board, with its recommendation for approval of the request, and memoranda prepared by the staff, and the Executive Board takes its decision. The Executive Board, it should he said, is composed of Executive Directors appointed or elected by members, and is the organ of the Fund that is in continuous session. A preoccupation of the Executive Board, the Managing Director, and the staff mission is that the program should he consistent with the "conditionality" that is appropriate to the member's circumstances.

The various intentions and policies of a member that make up its program may be drafted in more or less precise terms. Some of those that are precise will be made performance criteria that apply to purchases in the credit tranches beyond the first credit tranche [roughly 25 percent of the member's quota]. Performance criteria are certain elements in the program that are formulated in arithmetic or other objective terms. Formulation in this way is insisted on in order to avoid undermining the assurance that a member requires in support of its program. If performance criteria were not objective, the member might conclude that the Fund could impede purchases under the stand-by arrangement by decisions motivated by subjective or discretionary considerations. Performance criteria also give the Fund the assurance that it has reasonable safeguards for the proper use of its resources, as is required by Article 1(v). The practice of employing performance criteria developed because the Fund has a duty to see that a proper use is made of its resources, and a greater element of risk may be present when the assurance of future use is given. In fact, when the technique of the stand-by arrangement was being discussed, its legality was questioned for this reason As a result, the earliest stand-by arrangements were fbr short periods. Performance criteria were introduced at a later stage of the Fund's practice. . . .

There is no single code of performance criteria for all cases. One performance criterion that is always used is a ceiling on the expansion of credit by the central bank or the banking system, supported in most cases by a ceiling on the expansion of bank credit to the government or the public sector. Balance of payments problems often arise from national overspending, so that it becomes necessary to ensure that aggregate demand for goods and services is brought into line with output. Ceilings on the expansion of domestic credit help to regulate aggregate demand and to enhance the effectiveness of financial policies, including the channeling of sufficient credit to meet the needs of the private sector. If the policies on credit could have detrimental effects on employment and growth, policies must be devised to encourage savings and investment as well as a proper direction of investment.

Almost all stand-by arrangements include performance criteria that deal with the avoidance of all restrictions on payments and transfers for current international transactions as well as restrictions on imports for balance of payments reasons. If existing restrictions have resulted in substantial arrears in payments for current international transactions, a schedule for the aggregate reduction of them may be established as a performance criterion. If external debt service is a present or prospective burden on the balance of payments of undue proportions, limits on the amount and maturity of new short- and medium-term debt may be made a performance criterion. If the exchange rate for the member's currency is not consistent with underlying economic conditions, a performance criterion may take the form of minimum levels of net foreign exchange reserves, the effect of which is to restrain the use of reserves in intervention in the exchange market to support the exchange rate. . . .

To promote the efficacy of performance criteria, a stand-by arrangement, if it does not fall within the exception mentioned in the next paragraph, provides for the phased availability of the amount covered by the arrangement. The Fund has no general rule for determining the installments but adapts the phasing to the member's circumstances, including the urgency of its need for resources. . . .

Conditionality

The fundamental and distinctive characteristic of the Fund's financial assistance is the Fund's doctrine of conditionality. Four strands are woven into it. First, to qualify for the use of the Fund's resources in order to deal with a balance of payments problem, a member must he prepared to pursue policies that are designed to overcome its problem. The policies are often referred to as policies of adjustment of the balance of payments or as a stabilization program. The objective of the program is a balance of payments position that can be sustained over a medium term such as five to eight years ahead. A member's willingness to undertake a program is not a concession to the Fund. Adjustment is inevitable for any member that does not have the means to neglect adjustment. The conditionality of the Fund helps a member to achieve adjustment with the financial, technical, and moral support of the Fund. Second, the policies must be consistent with the purposes of the Fund. For example, the policies should enable the member to avoid the introduction of restrictions on trade and payments for balance of payments purposes and if possible eliminate existing restrictions, because restrictions are likely to intensify and riot correct the distortions that give rise to the need for adjustment, and are likely to he harmful to other members. Third, the policies must be designed to overcome the member's problem within a moderate ("temporary") period. Fourth, the policies must be likely to result in augmenting the member's monetary reserves so that it will be able to repurchase its currency from the Fund in accordance with the principle that use of the Fund's resources must be temporary in order that they can revolve for the benefit of all members.

Conditionality developed as a characteristic of the Fund's financial assistance without any reference to it in the Fund's original Articles. It became clear that the international monetary system needed an institution that could apply policies of conditionality without giving intolerable offense to its members. An effort to perform this function by another government would be resisted by a borrowing government as a trespass on its sovereignty. Private banks would seem to be even more officious if they made the attempt. Even regional organizations might find it embarrassing to call for truly corrective policies, because the action might appear inconsistent with the spirit of neighborliness. . . .

The purpose of conditionality is not to change the basic character or the organization of a member's economy. For example, the degree to which the economy is under government ownership or control is accepted as part of the framework within which a program of adjustment must be made to fit. Similarly, the social objectives or priorities of a member are accepted as beyond negotiation, subject to the proviso that the policies to promote them will permit the member to achieve a sustainable balance of payments position. In short, the Fund does not seek to modi~t the political or social policies of a member. The character of the Fund is determined by its technical tasks, the principle of universal membership, and the uniform treatment of all members. ...

It is sometimes said that conditionality is progressively more severe as the amounts made available ascend through the upper credit tranches. This proposition is doubtful because conditionality always has the same objective, the conquest of a member's balance of payments difficulty. It could even be argued that in many instances conditionality is less severe when more resources are made available. It may be easier for a government to give effect to a program over a longer period. Stand-by or extended arrangements for the longer periods that have become a feature of the Fund's practice in recent years tend to be associated with substantial amounts in terms of quota. The apparent truism that more time means more ease is not always true, however because a program for a longer period may require a perseverance that is politically difficult to maintain.

The word "harsh" is sometimes attached to particular operations involving conditionality. The inevitable determinant of the severity of a program, however it may be measured, is the intensity of a member's problem. Conditionality should be regarded as harsh only if it were to go beyond what was necessary to overcome a problem within the period that was reasonable in the circumstances, but this view does not mean that what is necessary in accordance with this criterion is always beyond controversy.

In discussing with a member a program that would meet the test of conditionality in the member's circumstances, the Fund does not insist that there is only one route by which adjustment can be reached. The purpose of the discussion is to elucidate the different policies that could be pursued to reach thi.s objective and to leave it to the member to choose the policies it prefers.

Performance criteria must not be equated with conditionality, because some of the policies that the Fund recommends are not, or cannot be, given the form of performance criteria. Nevertheless, performance criteria are an important element in conditionality, and much of the debate on this topic centers on them.

Performance criteria normally involve macroeconomic or aggregate variables, such as the financing requirement of the government, or the volume of external borrowing, or credit expansion within the economy. The Fund avoids performance criteria formulated in terms of microeconomic variables, such as the prices of commodities or services, particular subsidies, or particular taxes, although the Fund is interested in the internal consistency of a program and the measures that a member plans to take to meet performance criteria. In special circumstances, the Fund is willing to treat quantities related to some of these economic elements as performance criteria.

Concentration on the broadest economic aggregates that suffice to achieve adjustment enables the Fund to observe its policy of avoiding involvement in the distribution of the burden of adjustment among the different sections of society. But conditionality does affect sections of society, particularly in their incomes, and it gives rise, therefore, to fervent public and professional debate. Criticisms that have been made of conditionality have been based on its compatibility with the current state of the world economy, or on the economic theories implicit in conditionality as applied by the Fund, or on other aspects of the Fund's practice.

Conditionality has been criticized as too strict in the upper credit tranches because major changes of policy are expected within too short a period, with consequential political difficulties. Other criticisms have been that conditionality is too standardized, is correlated too closely with the features of the market economies of developed countries, limits growth unduly because of the emphasis on restraining demand, is not predictable when applied to individual members, and is undertaken in return for an inadequate amount of resources.

Criticisms such as those that have been mentioned would be valid if justified. Mr. Witteveen, the former Managing Director of the Fund, and Mr. de Larosière, the present Managing Director, have analyzed and replied to many of them.[5] This is not the occasion to rehearse their replies or to examine the extent to which the criticisms may be justified, but some general comments may be useful. It will be observed that some of the criticisms, such as those involving standardization and unpredictability, go in opposite directions. For political reasons and because other sources of financing may be available in substantial amounts in these days, a member may defer an approach to the Fund, so that the Fund becomes in fact as well as in theory the lender of last resort, When that stage is reached the member's difficulties may have become so acute that only a more rigorous program than would have been necessary for adjustment at an earlier date will solve the member's difficulties. Cases of this kind foster the impression that the Fund's resources are used only when a desperate situation arises, and that conditionality is always burdensome. These impressions tend to deter an approach to the Fund when difficulty is impending or at an early stage of difficulty, with the result that it becomes even harder to dispel them.

The Fund has responded to the problems that would be created by too rapid an adjustment by supporting programs of longer duration than one year, and by providing in some policies for repurchase over a longer span of time than the three to five years of the credit tranche policy. A similar attitude on the part of the Fund was responsible for its practice of approving stand-by arrangements for successive periods of a year, but in some instances progress under these arrangements was punctuated with intervals of retrogression. In recent years, programs formulated for a longer period; supported by stand-by or extended arrangements, have appeared to give greater hope or success in some circumstances. This practice not only spreads the burden of adjustment over time, but also broadens the range of policies from which a member may choose and gives it greater flexibility in determining when to introduce measures. The stand-by arrangement for one year continues to be appropriate for situations in which the disequilibrium is moderate and can be substantially corrected within that period, and for situations in which something of a holding action is advisable until a broader program can be formulated. Conditionality is the subject of debate, and even controversy, not only because of its effects on the policies of members but also because the national and international economic environment is in constant change and produces new problems for which solutions are not readily apparent. Nevertheless, conditionality is accepted in principle by most governments, although it is often. resisted in the form of its proposed application to them. This attitude is reminiscent of the definition of idealism as a code

5. *See* "Fund's Conditional Assistance Promotes Adjustment Programs of Members, Witteveen States," (an address by H. Johannes Witteveen, Managing Director, delivered May 8, 1978 in London before the 1978 Euromarkets Conference on Financing in LDCs: The Role of Public and Private Institutions), IMF Survey, Vol. 7 (May 22, 1978), pp. 145-50; and "Developing Nations' Mounting Problems Demand Bold Action, de Larosière Says," (an address by J. de Larosière, Managing Director, delivered May 11, 1979 before Fifth Session of UN Conference on Trade and Development in Manila), IMF Survey, Vol. 8 (May 21, 1979), pp. 149-52.

of conduct for others. The reluctance of some governments to adopt programs of adjustment should not obscure the fact that the strategy of other governments is to pursue the policies they would wish to follow in any event by enlisting the endorsement of the Fund and by presenting it publicly as a demand.

QUESTIONS

1. What would be your attitude, as a political official in a borrowing state, concerning IMF conditionality? As a hanker lending to that state?

2. How successful do you expect IMF conditionality programs to be in ensuring that states are able to repay loans? In the long run, would not the ability of borrowing states to repay the loans dependent on their success in developing their economies?

3. In its efforts to encourage a borrowing state to improve its balance of payments, what are the differences–for the state, for economic efficiency, and for the rest of the world–between encouraging the state to cut imports or encouraging it to increase exports? Note that the IMF has generally chosen the former approach, on the assumption that it can be implemented more quickly.

4. To what extent does the IMF function in effect as a cartel of private banks, imposing conditions on Third World states that the banks themselves desire, but are unable to enforce? In considering this, recognize that the IMF has regularly been involved in debt reschedulings since the mid-1970s, when international commercial banks sought to impose conditionality on Peru and failed.

5. The IMF's ability to adapt to changing circumstances and create new roles to fill was mentioned in the materials. Following the emergence of the debt crisis of less developed countries in the early 1980s, the IMF took on the role of encouraging private banks, particularly smaller regional ones, to continue lending to seriously indebted countries. This advocacy usually occurs after the IMF has reached an agreement with the debtor state. *See The IMF and Central Banks Flex Their Muscles*, EUROMONEY, January 1983, at 36.

6. Recall the excerpt from Stiglitz in Chapter X, *supra* at [redacted], in which he criticized IMF policies and their effects on developing states. Does the excerpt from Gold, *supra*, suggest any likely responses of the IMF to these criticisms?

7. The establishment of the IMF and the subsequent amendments of its Charter obviously were macroregulatory responses to major international financial crises. The next excerpt seeks to identify and assess not only these but also other contemporary crises that confront the IMF and the World Bank. Based on Gold's views–as well as Stiglitz's–what do you think the most effective responses to these crises might be? To put it another way, is there still a significant role for the IMF and the other Bretton Woods institutions in economic macroregulation and development policy? To what extent do the recommendations in the UK Commission for Africa report, discussed in Chapter XI, *supra* at [redacted], depend upon effective responses from the IMF and the other Bretton Woods institutions?

MICHAEL P. MALLOY, SHIFTING PARADIGMS: INSTITUTIONAL ROLES IN A CHANGING WORLD

62 FORDHAM L. REV. 1911 (1994)

Introduction

In July 1944, the representatives of forty-four allied powers met in Bretton Woods, New Hampshire, to plan the rebuilding of the international economic system in anticipation of the successful conclusion of the Second World War. . . . [A] series of institutional crises, some as yet unresolved, has fundamentally transformed the system constructed at Bretton Woods and that its vitality rests on its ability to maintain fidelity to its original values. . . .

II. Institutional Crises and Paradigm Shifts

Even in its formative period, the Bretton Woods system of international economic regulation was subjected to an institutional crisis that altered the structure of the system. The refusal of the U.S. Congress to implement the ITO Charter caused a structural realignment in the system. The result was the persistence of the GATT as a curious hybrid, lacking many of the formal characteristics of an "international organization"[66] but nonetheless functioning as a coordinate institution within the system. . . .

A. Repudiation by the Eastern Bloc

While the conference participants contemplated that the Bretton Woods system would be a set of "universal," though specialized institutions, the repudiation of membership by most Eastern Bloc countries, including the Union of Soviet Socialist Republics ("USSR"), robbed the system of the general applicability originally contemplated. Only now, in the aftermath of the political transformation of Central Europe and the political collapse of the USSR, is this distortion of the system being rectified.

B. Aggressive Use of Exchange Controls

Despite expectations that exchange controls would have limited utility within the rules of the IMF Charter, the opposite has generally been the case. Exchange controls and exchange arrangements have persisted, despite their ostensibly "transitional nature," under the charter.[69] Further, states have often employed them as economic sanctions.[70] Indeed, states have made attempts to enforce such controls transnationally through provisions of the IMF Charter requiring member deference to such controls where imposed consistent with the charter.[71] Thus, the practice concerning exchange controls under the IMF Charter would not seem consistent with the underlying charter objective of eliminating restrictions on current financial transactions.

C. 1971 Convertibility Crisis

The U.S. decision in 1971 to devalue the dollar and to refuse to allow redemption of dollars for gold represented the clearest example of an institutional crisis leading to a paradigm shift.[73] The immediate result was that the international monetary system was

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66. *See* IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 679-81 (3d ed. 1979) (identifying traditional criteria of legal personality in international organizations as permanent associations of states with legal objects and organs, distinction between the organization and its members, and internationally exercisable legal powers).

69. [Articles of Agreement of the International Monetary Fund, 60 Stat. 1401, T.I.A.S. No. 1501, 2 U.N.T.S. 39 (opened for signature and entered into force Dec. 27, 1945), as amended, 20 U.S.T. 2775, T.I.A.S. No. 6748 (May 31, 1968; effective July 28, 1969), 29 U.S.T. 2203, T.I.A.S. No. 8937 (Apr. 30, 1976; effective April 1, 1978) hereinafter IMF Articles], art. VIII, ¶ 2(a) (prohibition of restrictions on current payments). One stated exception to this prohibition is . . . for "transitional arrangements" for exchange restrictions, subject to a requirement of notification to the IMF. *See id.* art. XIV, ¶ 2. . . .

70. *See* MICHAEL P. MALLOY, ECONOMIC SANCTIONS AND U.S. TRADE 594-610 (1990 & 1993 Cum. Supp.) (discussing prevalence of currency restrictions as sanctions and relation between economic sanctions and IMF procedures).

71. *See* Richard W. Edwards, Jr., *Extraterritorial Application of the U.S. Iranian Assets Control Regulations*, 75 Am. J. Int'l L. 870, 873 (1981); *see also* Gerhard Wegen, *2(b) or Not 2(b): Fifty Years of Questions–The Practical Implications of Article VIII.2.b.*, 62 Fordham L. Rev. 1931 (1994).

73. For a discussion of the background of the President's decision to "close the gold window" and to impose other financial measures, including an import surtax, see *United States v. Yoshida Int'l, Inc.*, 526 F.2d 560 (C.C.P.A. 1975) (upholding President's imposition of the surtax). As Edwards has pointed out, it was not the refusal to redeem dollars for gold, but the accompanying refusal to intervene in the exchange markets to maintain dollar exchange rates within the limits then required by Article IV that constituted a violation of the IMF Charter. *See* [RICHARD W. EDWARDS, JR., INTERNATIONAL adrift throughout much of the 1970s and was reformulated by the end of the decade in several very significant ways.

Instead of the system of exchange parities established in the original version of the IMF Charter, a system of "managed floats" was established.[74] In addition, gold and the dollar have largely been replaced as the exchange system "pegs" in favor of the IMF-generated "special drawing right" ("SDR"), which is essentially a measure of value representing the value of a "basket" of currencies designated by the IMF. While this system, to some degree, has made the exchange rate system relatively less stable, the system is also less susceptible to the sort of crisis precipitated by the U.S. action in 1971.

D. 1982 LDC Debt Crisis

The LDC debt crisis, beginning in 1982 with Mexico's announcement that it would not service its external debt, was and continues to be a major institutional crisis for both the IMF and the World Bank. It remains a crisis–even if we may have become accustomed to living with it. It has heightened interest in the management and oversight of the global banking market, and one may reasonably ask what role the IMF should take in regulating this market.[77] . . .

The crisis also precipitated a paradigm shift with respect to the relative roles of the IMF and the World Bank. Despite the original expectation that the IMF would be involved in relatively short-term adjustment assistance, while the World Bank would be involved in long-term resource commitments, particularly in support of developmental projects, it may be that the two institutions have drifted into each other's respective areas of concern.[78]

E. Increasing Prominence of Regionalism

Cutting away from the universal and generally applicable character of the Bretton Woods system, the increasing prominence of regionalism in international economic arrangements, particularly in the area of international trade, also poses an institutional crisis for the system. Current and proposed regional arrangements do not have the precise symmetrical fit exhibited by the Bretton Woods model of international economic regulation. As these regional approaches continue to gain prominence, they are likely to require a reassessment of some underlying premises of the Bretton Woods system.[80]

III. Economic Transformation of the Former USSR

We are therefore dealing with a system of international economic regulation that has suffered considerable strains over the past fifty years. Intervening events have partially frustrated or reshaped some of its original objectives. . . . [The] current situation . . . could lead to an institutional crisis: the economic transformation of the fifteen republics

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MONETARY COLLABORATION] 497-98 [(1985)].

74. *See* Dominick Salvatore, *The International Monetary System: Past, Present, and Future*, 62 FORDHAM L. REV. 1975 (1994).

77. *See* Stephen T. Zamora, *Regulating the Global Banking Network–What Role (If Any) for the IMF*?, 62 FORDHAM L. REV. 1953 (1994).

78. *See* Dominique Carreau, *Why Not Merge the IMF and the World Bank*?, 62 FORDHAM L. REV. 1989 (1994). *See also* Cynthia C. Lichtenstein, *Aiding the Transformation of Economies: Has the Fund Become a Development Bank and the World Bank the Fund*?, 62 FORDHAM L. REV. 1943 (1994) (discussing institutional interrelationship between IMF and World Bank).

80. In particular, the objective of transparency of national boundaries with respect to international trade is put into question by regionalization trends. Indeed:

> the trend toward regional integration accelerated in 1992 both among industrial countries and developing countries. This reflected partly a deepening of existing trade arrangements and partly the stalemate in the Uruguay Round of GATT trade negotiations--which intensified fears of unilateral defensive trade actions and the need to increase bargaining power vis-a-vis other trading blocs, especially with the advent of the European single market and the North American Trade Agreement.

IMF, ANNUAL REPORT 16 (1993) (hereinafter 1993 Report).

of the former Soviet Union ("FSU").[81]

This crisis invites an obvious question: aside from its sheer size, what is so distinctive about the economic development project represented by the transformation of the FSU republics[82] that creates a potential crisis for the Bretton Woods system? One aspect of particular note here is the geopolitical linkage of the development project. Success of the political transformation of this Cold War nemesis depends, in no small part, on the success of the economic transformation.[83] . . .

IV. Economic Transformation and the Vindication of the Original Values of Bretton Woods

The challenge presented by the ongoing economic transformation of the FSU republics need not be viewed as a potential paradigm shift–not a challenge to the presuppositions that underlie the current Bretton Woods institutions–but rather, these may represent an opportunity to vindicate the objectives of those institutions. Whether those objectives are to be vindicated may depend, however, on the extent to which the Bretton Woods institutions, particularly the IMF, are willing to assume a proactive and primary role in the economic transformation. To date, there are reasons to doubt whether the institutions are willing to undertake such a role.

As late as April 1992, the Managing Director of the IMF delivered a formal address that seemed to commend the FSU republics to their own devices.[108] He repeatedly emphasized:

> Now comes the question of what the economic transformation will cost. Let me stress a basic fact. The transformation of the economies of the 15 republics is essentially their task. International financial assistance is critical, but it can only be a complement to their efforts, their savings, their investment in infrastructure and in expanding the productive base of the economy. . . . Yes, they will do the work. And history shows us that is how economic transformation happens.[109]

Ironically, this pronouncement on economic history contradicts the opening insight of the address. He acknowledged that "the magnitude of the problems facing the 15 republics is unprecedented. The challenge goes far beyond what is generally understood by the concept of economic transformation."[110] How is it then, if the challenge transcends our presupposed notions of economic transformation, that the FSU republics

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81. The terminology used to refer to the former republics has varied, but the IMF has lately adopted "FSU" as the operative term. *See, e.g.*, IMF, *International Financial Statistics: Supplement on Countries of the Former Soviet Union* ix (Supp. Series No. 16, 1993) (presenting microeconomic data and explaining notes pertaining to 14 FSU countries) (hereinafter FSU Supplement).

82. *See, e.g.*, [Michel] Camdessus, [*Economic Transformation in the Fifteen Republics of the Former U.S.S.R.: A Challenge or an Opportunity for the World*?] 1 [(address to Georgetown University School of Foreign Service, Apr. 15, 1992)] (noting that "magnitude of the problems facing the 15 republics is unprecedented").

83. *See* Jorge Braga de Macedo, *Comments*, in GEORG WINCKLER, CENTRAL AND EASTERN EUROPE ROADS TO GROWTH 138 (1992). He writes:

> Economic agents will not change their behavior if they do not believe that the policy environment has also changed irreversibly. . . . A move to free trade that is thought to be temporary will be welfare worsening. . . . Self-fulfilling expectations make reforms enduring if they are based on the rule of law. . . .

Id. at 140; *see also* Georg Winckler, *Roads to Growth: A Summary of Main Issues*, in GEORG WINCKLER, *supra*, at 4 (noting that "widespread distrust in the success of economic transition may further destabilize politics"); Thomas Friedman, *U.S. Asks Allies to Help Speed I.M.F. Aid to Russia*, N.Y. Times, Feb. 1, 1994, at A6, col. 1 (indicating U.S. concern over political need to support Russian reform efforts with immediate economic assistance).

108. *See* Camdessus, *supra* at 6.

109. *Id.*

110. *Id.* at 1.

are to be constrained by past experience with economic transformation?

The economic transformation that must occur in the FSU republics is fundamentally different from the problems that ordinarily confront developmental tacticians. It is not a situation calling for concentrated economic adjustment efforts along a continuum of development. Rather, it is a situation requiring a fundamental reconstruction of entire societies in all their legal, economic, and physical dimensions. By treating the challenge presented by the FSU republics as simply another, albeit larger, example of economic adjustment, the Managing Director makes it, in broad outline, indistinguishable from all other economic adjustment challenges facing the Bretton Woods institutions. Thus, he observed:

> Because the IMF is a universal institution, we must consider these new demands in a global context and try to reconcile them with the other challenges to the world economy:
>
> • the heavy investments needed in the industrial countries themselves, to support their own growth in the decade ahead;
>
> • the investment needs of the developing countries, to promote their development, protect the environment, reduce poverty, and complete the job of solving the debt problem . . . .[111]

This homogenization of the varied challenges presented by economic transformation of the FSU republics and other continuing developmental problems is misplaced and dangerous. Without appropriate attention to the preeminent challenge represented by the critical situation in the FSU republics, there exists the very real possibility of fundamental instability in international peace and security surpassing even the pre-transformation period of the Cold War. Furthermore, this undifferentiated approach to current developmental problems subverts a key, original value of the Bretton Woods System: the priority of reconstruction over development.[112]

The Bretton Woods System presupposed that reconstruction would naturally precede broader development efforts.[113] In the case of the FSU republics, however, that presupposition went seriously awry. In a very real sense, they have existed in a state of suspended animation, never enjoying the post-war reconstruction that revitalized Western Europe. With that suspension now reversed, priority should be given to their reconstruction. Unfortunately, . . . the relative realignment of the role of the World Bank, originally charged with the reconstruction and development objectives of the System, has caused these functions to apparently fall to the IMF, without the direct application of the World Bank's charter commitment to the priority of reconstruction efforts over developmental projects. This "lowest common denominator" approach to the critical task of economic transformation to the FSU republics may ultimately fail its

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111. *Id.* at 7.

112. Compare the IBRD Charter which states:

> The purposes of the Bank for Reconstruction and Development are:
>
> (i) To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peacetime needs and the encouragement of the development of productive facilities and resources in less developed countries. . . .
>
> (v) To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a wartime to a peacetime economy.

IBRD Articles, *supra*, art. I, ¶¶ i, v.

113. *See id.*

fundamental purpose.[116]

2. Private Law Implications

Two important private law issues derive directly from the international monetary system. The first is the "gold clause," the approach a private creditor uses to protect itself from fluctuating exchange rates. Thus, contractual language would denominate a debt not as a duty to pay so many dollars but as a duty to pay the *current dollar equivalent* of so much gold, or so many Swiss francs, or the creditor's choice between different specified currencies, or even so many SDRs. Courts will almost always respect a relevant currency choice for an actual international transaction, such as the use of dollars or of Swiss francs for a U.S. sale to Switzerland. However, this is not always the case when the transaction is domestic–governments argue that they need to have the right to overrule these clauses in order to make their domestic economic regulation effective. Thus the U.S. Supreme Court, for example, upheld New Deal regulations making gold clauses (in a domestic context) unenforceable. *See Norman v. Baltimore & Ohio R.R. Co.*, 294 U.S. 240 (1935). This position–which was also taken by many other states–is likewise being globally reversed (by statute in the United States) in the new era of floating exchange rates.[1]

The second private law issue is that of "exchange restrictions." In order to avoid modifying their currency values and in order to protect limited stores of hard currency, states often apply such exchange controls. For a debtor state, the most common one is to centralize all exchange transactions; a government agency accumulates all the hard currency and rations it out for the purposes it finds most important. Other options include multiple exchange rates. For example, in the early 1970s France was running a balance-of-payments deficit at a time when it wanted to maintain a high interest rate. The high interest rate would attract investment funds, bidding up the exchange rate and hurting the nation's trade balance. France therefore separated the two markets through careful regulations designed to allow the "financial [investment] franc" to be bid up while the "commercial [trade] franc" floated down to help clear the balance of trade market. In a third variation, the United States imposed direct regulations in the 1960s.

Creditor states use different systems. German and Swiss laws, for example, have frequently required investors or banks to pay a special tax on foreign deposits or to maintain special reserves against these deposits. The result is that the banks offer a lower interest rate on such accounts, which are thereby discouraged.

These rules can create great difficulties for an investor that wants to repatriate its income or its principal. The IMF generally dislikes such rules, but does have a procedure for approving them (a nearly automatic procedure requiring affirmative action for disapproval). When such rules are approved, other IMF member states are not to assist in evading them, as explained in the following case.

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116. The IMF has already been subjected to growing criticism over its handling of the economic transformation of the FSU republics. *See, e.g.*, Friedman, *supra* note 84, at A6 (discussing U.S. concern over delays in IMF assistance to Russia).

1. *E.g.*, Pub. L. No. 95-147 (Secretary of Treasury authorization), Oct. 28, 1977. Note, however, that in *Trans World Airlines v. Franklin Mint*, --- U.S. --- 104 S. Ct. 1776 (1984), the Court regarded the air carrier's Warsaw Convention liability "limit" for lost cargo of 250 gold French francs per kilogram as not rising with the freed post-1978 unofficial price of gold.

36 N.Y.2d 592 (1975)

JASEN, J.

The principal question before us is whether a private foreign bank may avail itself of the New York courts in an action for damages for tortious fraud and deceit and for rescission of currency exchange contracts arising from alleged violations of foreign currency exchange regulations.

Plaintiff, a private Brazilian bank, brings this action for fraud and deceit, and conspiracy to defraud and deceive, against 20 “John Doe” defendants whose identities are unknown to it. The gravamen of plaintiff’s complaint is that these defendants over a period of approximately six weeks participated, in violation of Brazilian currency regulations, in the submission of false applications to Banco Brasileiro of Brazil, which the plaintiff relied upon, resulting in the improper exchange by the bank of Brazilian cruzeiros into travelers checks in United States dollars totaling $1,024,000.

It is an old chestnut in conflict of laws that one State does not enforce the revenue laws of another. By way of rationale, an analogy is drawn to foreign penal laws, extra-state enforcement of which is denied *(see The Antelope*, 10 Wheat. [23 U.S.] 66, 123) to deny recognition to foreign tax assessments, judicially expanded also to include foreign currency exchange regulations. The analogy, reformulated in the Restatement (Restatement, Conflict of Laws, §§6l0, 611), but interestingly withdrawn in the Restatement Second (§89), traces from Lord Mansfield’s now famous dictum in an international smuggling case that “no country ever takes notice of the *revenue* laws of another.” (*Holman v. Johnson*, 1 Cowp. 341, 343.) But the modern analog of the revenue law rule is justifiable neither precedentially nor analytically.

Holman v. Johnson was an action for goods had and received. The plaintiffs, Frenchmen, sold and delivered tea to the defendant in France. The tea was then smuggled into England by the defendant in violation of the revenue laws. In an action for the price, Lord Mansfield’s holding was simply to the effect that a French court would not invalidate a sale of tea by a Frenchman in France made in violation of an English prohibition. The decision was concerned largely with the impact of foreign revenue laws on international commerce, but the quoted dictum became the basis in this country for denying foreign tax authorities the right to collect taxes assessed by them. But certainly that case and earlier (*e.g., Boucher v. Lawson*, 95 Eng. Rep. 53) and later (*e.g., Planché v. Fletcher*, 1 Dougl. 250) dicta in other cases denying extraterritorial effect to forum defenses, should not have been relied upon to deny forum effect to foreign claims.

Nor is the rule analytically justifiable. Indeed, much doubt has been expressed that the reasons advanced for the rule, if ever valid, remain so. (*E.g*., Lefiar, *Extrastate Enfbrcement of Penal and Governmental Claims*, 46 Harv. L. Rev. 193.) But inroads have been made. In interstate cases, for example, where the rule made least sense, administrative tax assessments are increasingly equated with tax judgments . . . and on that basis generally afforded full faith and credit. . . . Some do consider that, in light of the economic interdependence of all nations, the courts should be receptive even to extranational tax and revenue claims as well, especially where there is a treaty involved, but also without such constraint. (Scoles, *Interstate and International Distinctions in Conflict of Laws in the United States*, 54 Cal. L. Rev. 1599, 1607-1608.) Indeed, there may be strong policy reasons for specially favoring a foreign revenue regulation, using that term in its broadest sense, especially one involving currency exchange or control.

In the international sphere, cases involving foreign currency exchange regulations represent perhaps the most important aspect of the revenue law rule. This assumes, of course, that a currency exchange regulation, normally not designed for revenue purposes as such, but rather, to prevent the loss of foreign currency which in turn increases the country's foreign exchange reserves, is properly characterizable as a revenue law. (*Contra, Kahler v. Midland Bank* [1950] A.C. 24; Dicey, Conflict of Laws [7th ed], p. 920.) At any rate, it is for the forum to characterize such a regulation and in this State the question would appear to have been resolved for the present at least by *Banco do Brasil v. Israel Commodity Co.*, 12 N.Y.2d 371, 377, 239 N.Y.S.2d 872, 875, 190 N.E.2d 235, 237, *cert. den.*, 376 U.S. 906. . . .

But even assuming the continuing validity of the revenue law rule and the correctness of the characterization of a currency exchange regulation thereunder, United States membership in the International Monetary Fund (IMF) makes inappropriate the refusal to entertain the instant claim. The view that nothing in article VIII (§2, subd. [b]) of the Bretton Woods Agreements Act (60 U.S. Stat. 1401, 141 l)* requires an American court to provide a forum for a private tort remedy, while correct in a literal sense (*see Banco do Brasil v. Israel Commodity Co.*, *supra*, p. 376, 239 N.Y.S.2d p. 874, 190 N.E.2d p. 236), does not represent the only perspective. Nothing in the agreement prevents an IMF member from aiding, directly or indirectly, a fellow member in making its exchange regulations effective. And United States membership in the IMF makes it impossible to conclude that the currency control laws of other member States are offensive to this State's public policy so as to preclude suit in tort by a private party. Indeed, conduct reasonably necessary to protect the foreign exchange resources of a country does not offend against international law. (Restatement, 2d, Foreign Relations Law of the United States, §198, comment *b*.) Moreover, where a true governmental interest of a friendly nation is involved–and foreign currency reserves are of vital importance to a country plagued by balance of payments difficulties–the national policy of co-operation with Bretton Woods signatories is furthered by providing a State forum for suit.

The *Banco do Brasil* case relied upon by the Appellate Division is quite distinguishable. There the Government of Brazil, through Banco do Brasil, a government bank, sought redress for violations of its currency exchange. regulations incident to a fraudulent coffee export transaction. Here, the plaintiff is a private bank seeking rescission of the fraudulent currency exchange transactions and damages. And no case has come to our attention where a private tort remedy arising from foreign currency regulations has been denied by the forum as an application of the revenue law rule and we decline so to extend the *Banco do Brasil* rationale. Thus, in the instant case we find no basis for reliance upon the revenue law rule to deny a forum for suit. Moreover, where the parties are private, the "jealous sovereign" rationale is inapposite (*cf. Loucks v. Standard Oil Co.*, 224 N.Y. 99, 102-103, 120 N.E. 198, 199 [Cardozo, J.]) even as it might seem inapposite in the *Banco do Brasil* situation where the sovereign itself, or its instrumentality, asks redress and damages in a foreign forum for violation of the sovereign's currency laws. (*But cf. Moore v. Mitchell*, 2Cir., 30F.2d 600, 603 [L. Hand, J., concurring].)

Perutz v. Bohemian Discount Bank in Liquidation, 304 N.Y. 533, 110 N.E.2d 6, is

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***.** There it is provided in relevant part: "Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member. In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective."

consistent with an expansive application of the IMF agreement to which we here ascribe (*cf. Kolovrat v. Oregon*, 366 U.S. 187, 196-198), although there it is true defensive use of foreign currency exchange regulation was made and upheld by this court. But interestingly, in *Perutz*, in contrast to the instant case, political relations at the time were not conducive to comity which nevertheless was extended. . . .

Finally, subsequent to the commencement of this action, a penalty was levied by the Central Bank of Brazil, and paid by the plaintiff, on account of the alleged fraudulent currency exchange transactions. Therefore, our decision today is without prejudice to a proper application by plaintiff to Special Term to allege by supplemental pleading such sum as an element of special damages on the third cause of action. (C.P.L.R.. 3025, subd. [b]; *cf. Morrison v. National Broadcasting Co.*, 19 N.Y.2d 453, 280 N.YS.2d 641, 227 N.E.2d 572.)

Accordingly, the order of the Appellate Division should be modified in accordance with the views here expressed and the action remitted to the Supreme Court, New York County.

WACHTLER, J. (dissenting).

I believe that the relief sought here, albeit indirectly through plaintiff bank, is an aspect of the Brazilian government's sovereign management of the economy of its own country. This is not a matter involving the resolution of private rights only as those rights are defined under the laws of a foreign State. Were that so our courts would not withhold judicial sanction even if the definition of such private rights were somewhat different from our own, "unless some sound reason of public policy makes it unwise for us to lend our aid" (*Loucks v. Standard Oil Co.*, 224 N.Y. 99, 110, 120 N.E. 198, 201).

There is no allegation in this complaint that defendants intended to or succeeded in defrauding plaintiff of foreign currency exchange in the private rights sense. On the contrary, from all that appears, defendants obtained no more United States dollars in consequence of their alleged fraud than they would have been entitled to receive at the then currently effective exchange rate for the Brazilian cruzeiros which they exchanged with plaintiff bank. The gravamen rather is that the fraud and deceit practiced by the defendants induced plaintiff bank to violate Brazilian currency exchange regulations, thereby exposing that bank to consequent penalties which would be imposed by the Brazilian Government.

It has long been recognized that the courts of one jurisdiction will riot enforce the tax laws, penal laws, or statutory penalties and forfeitures of another jurisdiction. "The rule that the courts of no country execute the penal laws of another applies, not only to prosecutions and sentences for crimes and misdemeanors, but to all suits in favor of the state for the recovery of pecuniary penalties for any violation of statutes for the protection of its revenue, or other municipal laws." (*Wisconsin v. Pelican Ins. Co.*, 127 U.S. 265, 290; . . .) Under the principle of territorial supremacy, fundamental to the community of nations, courts refuse to enforce any claim which in their view is a manifestation of a foreign State's sovereign authority (Dicey & Morris, Conflict of Laws [8th ed.], p. 160; *cf.* Judge Learned Hand's concurring opinion in *Moore v. Mitchell*, 2 Cir., 30 F.2d 600). The proper question is whether in the particular instance the claim sought to be enforced is a manifestation of such sovereign authority.

In previous cases our court held that governmental foreign exchange regulation may present an aspect of the exercise of sovereign power by a foreign State to implement its national fiscal policy. Thus, in *Banco do Brasil v. Israel Commodity Co.* (*supra*), we decided that our courts were not open to enforce a Brazilian foreign currency exchange regulation. Although the regulation in that case was characterized as a revenue measure, the essence of the matter was that we declined to enforce what we considered to be an exercise of Brazil's sovereign power. Whether a regulation denominated "currency exchange regulation" has or does not have a revenue-producing effect, it must be presumed to have been adopted to accomplish fiscal regulation and ultimate economic objectives significantly similar to, if not identical with, the objectives which underlie what would be characterized as revenue measures–narnely, governmental management of its economy by a foreign country. Accordingly, the result is not determined by the threshold appearance of the particular law sought to be enforced or whether such law be denominated by the foreign government as a penal law or a revenue law or otherwise. The bottom line is that the courts of one country will not enforce the laws adopted by another country in the exercise of its sovereign capacity for the purpose of fiscal regulation and management.

Although our earlier decisions in *Perutz v. Bohemian Discount Bank in Liquidation*, 304 N.Y. 533, 110 N.E.2d 6, and *Industrial Export & Import Corp. v. Hongkong & Shanghai Banking Corp.*, 302 N.Y. 342, 98 N.E.2d 466, may appear to be to the contrary, a studied analysis dispels this apparent inconsistency. These cases merely refine the traditional conflict-of-laws rule by holding that the provisions of any international agreement to which the United States is a party supplement, and to that extent, supersede the traditional rule. For instance, the Bretton Woods Agreements Act (U.S. Code, tit. 22, §286), authorizes United States membership in the International Monetary Fund (60 U.S. Stat. 1401; 2 U.S. Treaty Developments, Dec. 27, 1945, T.I.A.S. 1501). Another example of such a treaty is article VIII (§2, subd. [b]) of the international Monetary Fund Agreement (60 U.S. Stat. 1411) making exchange contracts which are contrary to the exchange control regulations of a member (Brazil is a member) unenforceable in the territory of another member (United States). So in *Perutz* (*supra*), relying on the provisions of the Bretton Woods Agreements Act we refused to enforce a private agreement contrary to Czechoslovakian exchange control regulations. Similarly, in *Industrial Export & Import Corp*. (*supra*), we refused to enforce a private contract contrary to the currency regulations of China on the basis of a separate agreement between the United States and China. Thus, by treaty provision what would otherwise have been the applicable rule of judicial nonrecognition of sovereign acts of a foreign State may be modified in the area of currency exchange control to require courts in the member States (including courts in the United States) to recognize foreign currency regulation as a *defense*.

Nothing in the Bretton Woods Agreements Act or in any other agreement between the United States and Brazil of which we are aware, however, mandates a complete abrogation of the normal conflicts rule or requires our courts *affirmatively* to enforce foreign currency regulation, as we are invited to do in the present case. This distinction was expressly recognized and held to be dispositive in *Banco do Brasil* (*supra*), in which we said (12 N.Y.2d p. 376, 239 N.Y.S.2d p. 874, 190 N.E.2d p. 237): "An obligation to withhold judicial assistance to secure the benefits of such contracts [*i.e*., those violative of the foreign currency control regulation] does not imply an obligation to impose tort penalties on those who have fully executed them." (*See* Dicey & Morris, Conflict of Laws 18th ed.], *op. cit.*, p. 161, n. 19; pp. 898-900.)

The appellant seeks to distinguish our decision in *Banco do Brasil* on the ground that the plaintiff in that case was recognized as an instrumentality of the Brazilian Government. I find this unpersuasive. As Judge Cardozo noted in the *Loucks* case (*supra*), a statute will be deemed to reflect the Sovereign's interest if it "awards a penalty to the state, or to a public officer in its behalf, or to a member of the public, suing in the interest of the whole community to redress a public wrong. . . . The purpose must be, not reparation to one aggrieved, but vindication of the public justice." (*Loucks v. Standard Oil Co., supra,* 224 N.Y. pp. 102-103, 120 N.E. p. 198; *cf. Huntington v. Attrill, supra*, 146 U.S. pp. 673, 681-682, 138. Ct. 224). Whenever vindication of the public interest is sought at the instance of a third person, as here by plaintiff bank, of necessity such third party must show "aggrievement" or no cause of action will lie. But any such formulation is incomplete.

The core of the issue here is enforcement of a Brazilian currency exchange regulation. The only "reparation" sought by this plaintiff is for damages sustained in consequence of violation of that regulation–penalties to be imposed on it by the Brazilian Government plus associated injury to its business and reputation in consequence of such violation. Damages which are wholly attributable to violation of such a regulation, although alleged to have been occasioned by defendants' fraud, do not convert the action to one solely for private reparation. The ultimate economic reality, of granting relief to the plaintiff bank, would be the imposition on defendants of sanctions for violation of currency exchange control.

I recognize that this case is not an instance of recourse sought by a foreign country in our courts for the direct enforcement of its foreign currency exchange regulations, as would be the case were the Brazilian Government seeking here to recover penalties from either Banco Brasileiro or from the defendants. The rights of private parties will be significantly affected; it is alleged that plaintiff bank has suffered and will suffer detriment in its private capacity in consequence of the fraud and deceit of defendants. The resolution of the issue posed by the motion to dismiss does not depend on the incidental, inescapable fact that private rights have already been, and would be affected by the judicial relief sought. Rather, the determinative factor is that the primary objective and the ultimate practical effect of the relief sought would be the enforcement of the currency regulation system of a foreign country. Our courts are not open for the accomplishment of that end, and that it may be sought through private intermediaries does not change the result. It matters not whether enforcement is sought directly or indirectly (Dicey & Morris. Conflict of Laws [8th ed], *op. cit.*, pp. 160-161).

I consider the plaintiff's complaint as an attempt to utilize the judicial machinery of our courts to enforce the exercise of the sovereign power by the Government of Brazil. I believe that our courts, under traditional and established principle, are not available for this purpose.

The majority, however, argues that the time may have come for a change in what historically has been the applicable rule. I recognize that strong arguments can be mounted for a change in view of the increased frequency and importance of international commerce and the significantly different perspective in today's world in which one nation views another nation and its interests. In my opinion, however, the responsibility for any change lies with our Federal Government rather than with the highest court of any single State. Change, if at all, in my view, would better come at the hands of the State Department and the Congress, through the negotiation of international agreement or otherwise in the discharge of the constitutional responsibility of the Federal Government "to regulate commerce with foreign nations" (*cf*. Bretton Woods Agreements Act), A fitting sense of judicial restraint would dictate that the courts of no single State should enunciate a change, however large that State's relative proportion of foreign commerce may be, particularly since the authoritative effect thereof would necessarily be confined to the borders of that State.

Accordingly, I believe the order of the Appellate Division should he affirmed.

NOTES AND QUESTIONS

1. The *Banco Frances* case, applying the IMF treaty, suggests a principle suitable to exchange control restrictions. These restrictions do not necessarily prohibit all payment; it is understandable for the sake of an orderly international monetary system that they riot be undercut by foreign judicial action. Another equally intelligible principle evolved and was recently restated in the *Vishipco* case, *infra*. This principle holds that a bank with international branches should not, in general, be able to resist liability to a depositor who invested in a branch that was since closed.

2. As this body of law evolved, it evaluated the impact of the foreign government's policy in expropriation or act of state terms, typically relying heavily on whether a conceptual "situs" or location of the debt was in the foreign state. In *Vishipco* as in *Garcia v. Chase Manhattan Bank*, 735 F.2d (2d. Cir. 1984), the situs was found to be no longer in the foreign state. However, the legal analysis in *Garcia* was discredited in *Perez v. Chase Manhattan Bank,* 61 N.Y.2d 469, 463 N.E.2d 5 (1984), a case presenting facts virtually identical to those in *Garcia*, in which the New York Court of Appeals noted that *Garcia* had relied on a lower New York state court ruling overturned by *Perez*.

3. *Banco Frances* has not had the effect of blunting the impact of the revenue rule. The case that follows represents a recent application of the revenue rule.

EUROPEAN COMMUNITY v. RJR NABISCO, INC.

355 F.3d 123 (2d Cir. 2004)

SOTOMAYOR, CIRCUIT JUDGE

Plaintiffs-appellants are the European Community ("EC") and various of its member states (collectively, the "EC plaintiffs"), as well as certain Departments of the nation of Colombia (the "Departments of Colombia," and collectively with the EC plaintiffs, "plaintiffs"). They appeal from the judgment of the United States District Court for the Eastern District of New York (Garaufis, J.), dismissing their complaints in three related suits against the defendants, tobacco product manufacturers Philip Morris, RJR Nabisco, Brown & Williamson Tobacco Corp., British American Tobacco, Japan Tobacco, Inc., and each one's affiliated entities. Plaintiffs allege that the defendants have violated the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961 *et seq.,* by masterminding several ongoing schemes to smuggle contraband cigarettes into the plaintiffs' territories. In the process, the defendants allegedly have entered into conspiracies to commit mail and wire fraud, money laundering, misrepresentations to customs authorities, and various common law torts. Plaintiffs claim that the defendants' conduct has caused them economic harm in the form of lost tax revenues and law enforcement costs. The district court dismissed the complaints in their entirety, finding that because plaintiffs' claims were premised on purported violations of their tax laws, they would require the court to interpret and enforce foreign revenue laws, in violation of the revenue rule and this Court's holding in *Attorney General of Canada v. R.J. Reynolds Tobacco Holdings, Inc.,* 268 F.3d 103 (2d Cir.2001) ("*Canada* "), *cert. denied,* 537 U.S. 1000 (2002). . . .

Background . . .

The EC plaintiffs allege that the tobacco companies directed and facilitated contraband cigarette smuggling by studying smuggling routes, soliciting smugglers, and supplying them with cigarettes encased in packages that allowed the defendants to monitor and control the smuggling. The smugglers would then forge shipping documents and route the cigarettes so as to avoid paying the customs duties and excise taxes of the countries into which the cigarettes were smuggled. The profits from the smuggling were partially funneled into bonuses and kickbacks for defendants' executives. Facilitating the smuggling trade also enabled the tobacco companies to argue to the public and the EC that the high import taxes maintained by the EC's member states were fostering a black market in cigarettes. Moreover, the defendants allegedly knew or should have known that the funds used by the smugglers to purchase the cigarettes were generated through the sale of illegal narcotics in the United States and then laundered through a black market money exchange before being paid to the defendants.

The Departments of Colombia make similar allegations, claiming that the defendants have established and maintained small volumes of legal cigarette sales in Colombia in order to conceal and facilitate the many illegal shipping routes into the country. Some of the defendants collectively engaged in a number of meetings to coordinate their use of smuggling and to fix the prices of smuggled cigarettes. They have also labeled their products so as to exercise control over the smuggling, have secreted the proceeds in Swiss banks, and have lobbied for lower import taxes on the ground that high taxes promote smuggling. Finally, the defendants allegedly were aware that Colombian smugglers were funding their smuggling activities with the laundered proceeds of narcotics sales made in the United States.

The plaintiffs assert that the defendants and others participated in a smuggling enterprise within the meaning of RICO, *see* 18 U.S.C. § 1961(4), and that they committed a number of predicate acts of racketeering, including wire and mail fraud, money laundering arising from both the defendants' acceptance of the proceeds from narcotics trafficking as payment for cigarettes and their attempts to conceal their smuggling profits, and violations of the Travel Act, 18 U.S.C. §§ 1952, 1961(1)(B). They also assert a number of state common law claims against the defendants, including negligent misrepresentation, public nuisance, unjust enrichment, and common law fraud. . . .

. . . In October 2001, this Court decided *Canada,* holding that claims by foreign sovereigns that were premised on violations of foreign tax laws are barred by the revenue rule. *Canada,* 268 F.3d at 126. Based on our holding in *Canada,* the defendants in the EC plaintiffs' lawsuit moved to dismiss the complaint in December 2001. . . .

The district court held that plaintiffs' RICO claims were premised on lost tax revenues, and *Canada* therefore required that all of the claims be dismissed. . . . Although plaintiffs' complaints do not distinguish between "smuggling" and "money laundering" claims, but simply allege both types of conduct as predicate acts of racketeering under RICO, the district court treated them separately in its decision. The court dismissed the smuggling claims on the basis of the revenue rule, reasoning that, like the plaintiff foreign sovereign in *Canada,* plaintiffs here sought relief based solely on lost tax revenues and expenditures made in furtherance of their revenue laws. Adjudicating the claims would therefore require the court to interpret and enforce foreign revenue laws, in contravention of *Canada*'s holding that, in most circumstances, courts may not pass upon foreign tax laws. . . . Responding to plaintiffs' argument that our holding in *Canada* was displaced by the passage of [the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism

(USA PATRIOT) Act of 2001, Pub.L. No. 107-56, 115 Stat. 272 ("the Patriot Act")], the court concluded that the text and legislative history of the Act's RICO amendments did not provide clear evidence of congressional intent to abrogate the revenue rule. . . . The court also dismissed the money laundering claims without prejudice, finding that these claims were premised on the alleged smuggling scheme because they involved the laundering of the funds for, and proceeds from, the smuggling activities. . . . When considered independently of the smuggling allegations barred by the revenue rule, therefore, the money laundering claims did not allege any causal connection between the alleged money laundering and the lost tax revenues. ... The district court entered judgment dismissing the complaints in all three actions on March 21, 2002. The court dismissed the smuggling claims with prejudice, and the money laundering claims without prejudice. This appeal followed.

Discussion

On appeal, plaintiffs raise a number of challenges to the district court's dismissal of the three complaints. With respect to the court's decision on the merits, plaintiffs concede that our decision in *Canada* establishes that suits to enforce foreign tax laws implicate the revenue rule, but argue primarily that the legislative history of the Patriot Act, passed in October 2001, evinces congressional intent to allow foreign sovereigns to use RICO to sue tobacco companies for lost tax revenues. Thus, plaintiffs contend that the Patriot Act requires us to find that Congress has abrogated the revenue rule for the purposes of RICO suits. Plaintiffs also attempt to distinguish their claims from those at issue in *Canada* by arguing that the revenue rule is not triggered here because the executive branch has indicated its consent to this suit, and that the district court misconstrued the revenue rule as an absolute bar to suit rather than a discretionary rule, and consequently failed to exercise its discretion. . . .

I. The Revenue Rule Holding

A. *Canada* 's Explication of the Revenue Rule

We explained in *Canada* that the common law revenue rule holds that the "courts of one sovereign will not enforce final tax judgments or unadjudicated tax claims of other sovereigns." *Canada*, 268 F.3d at 109. The revenue rule is implicated whenever "the substance of the claim is, either directly or indirectly, one for tax revenues," *id.* at 130, such that "the whole object of the suit is to collect tax for a foreign revenue, and that this will be the sole result of a decision in favour of the plaintiff," *id.* at 131 (quoting *United States v. Harden*, [1963] S.C.R. 366, 371). A suit directly seeks to enforce foreign tax laws when a judgment in favor of the plaintiffs would require the defendants to reimburse them for lost tax revenues. In contrast, indirect enforcement occurs when a foreign state seeks a remedy that would give extraterritorial effect to its tax laws; for instance, a suit seeking damages based on law enforcement costs is an attempt to shift the cost of enforcing the tax laws onto the defendants, and would therefore require the court indirectly to enforce the tax laws. *Id.* at 131-32.

Canada holds that the revenue rule reflects both sovereignty and separation of powers concerns. *Id.* at 126. The courts of one sovereign will not enforce the laws of another sovereign if they are contrary to the public policy of the forum state. Tax laws strongly implicate this principle, as they often embody the political and social judgments of the sovereign and its people. Accordingly, claims by foreign sovereigns invoking their tax statutes may embroil the courts in an evaluation of the foreign nation's social policies, an inquiry that can be embarrassing to that nation and damaging to the forum state. *Id.* at 112. Moreover, because the conduct of foreign relations is primarily the realm of the legislative and executive branches, judicial examination and enforcement of foreign tax laws at the behest of foreign nations may conflict with the other branches' policy choices with respect to cooperation in tax enforcement, and create the risk that the judiciary will be "drawn into issues and disputes of foreign relations policy that are assigned to–and better handled by–the political branches of government." *Id.* at 114-16, 123.

Although the revenue rule arose out of the pragmatic desire of eighteenth-century English judges to promote "British trade that would otherwise have been unlawful," *European Community II,* 186 F.Supp.2d at 234 (internal quotation marks omitted), we held that it remains in force because it continues to protect modern separation of powers and sovereignty concerns, *Canada,* 268 F.3d at 109-15. In *Canada,* we undertook an extensive examination of the tax treaties in effect between the United States and other nations, and concluded that their grant of only limited reciprocal tax enforcement assistance reflected the political branches' continuing recognition of the revenue rule. *Id.* at 115-19. Thus, the modern revenue rule is rooted in both our perception that the branches of government responsible for conducting foreign affairs wish to uphold the rule, and our reluctance to intrude upon the greater expertise of the political branches by abrogating the rule without evidence that doing so would be consonant with the policies of the other branches.

The revenue rule is therefore not absolute. Even if the substance of the claim invokes foreign tax laws, the revenue rule will not be triggered where the sovereignty and extraterritoriality concerns that inform the rule's application are not present. Thus, for example, where the executive branch has "expressed its consent to adjudication by the courts," the institutional and separation of powers concerns behind the rule are mitigated, because the branch with primary responsibility for conducting foreign relations has indicated that extraterritorial enforcement of the foreign tax laws at issue is in the interests of the United States. *Id.* at 113, 123 n. 25. In *Canada,* we suggested that executive consent may be found where the United States itself institutes a prosecution designed to punish those who have defrauded foreign governments of tax revenues, or where the treaties between the United States and the sovereigns at issue provide for broad, reciprocal tax enforcement assistance. *Id.* at 113, 121-24 & nn.24-25. The executive also might indicate its consent to the suit by other means, such as submitting a statement from the State Department or filing an amicus brief.

Absent such indication that the executive branch consents to the suit, a claim that triggers the revenue rule is barred unless the plaintiffs establish that superior law, such as the federal statute that provides the applicable right of action, abrogates the rule in the context in which the plaintiffs seek to enforce their tax laws. *See id.* at 113, 119, 126. Because the revenue rule is a longstanding common law rule, and its abrogation in any one situation necessarily impacts foreign relations, a statute or treaty "must speak directly to the matter" in order to abrogate it. *Id.* at 129 (internal quotation marks omitted). In *Canada,* we held that RICO, as enacted in 1970, does not contain the clear evidence of congressional intent necessary to rebut the presumption that statutes are enacted against the background of the common law and abrogate the revenue rule. *Id.* We found nothing in RICO's text that explicitly authorizes foreign nations to use RICO's civil remedy provisions to enforce their tax laws extraterritorially, and its legislative history did not contain any manifestation of congressional intent to grant such authorization. *Id.*

B. Application of the Revenue Rule to Plaintiffs' Allegations

The allegations in plaintiffs' complaint are markedly similar to those at issue in *Canada.* Plaintiffs are foreign sovereigns attempting to use RICO to impose liability on various domestic and foreign tobacco companies for smuggling and money laundering, premising their assertions of injury to business and property on the taxes that they would have levied on the cigarettes, had they been legitimately imported, and on the costs of enforcing their tax laws. *Cf. id.* at 132-33. Because plaintiffs' claims arise exclusively from tax-related losses and costs, adjudicating these claims would implicate the concerns discussed in *Canada*, requiring the court to evaluate the policies behind the relevant foreign tax laws, interpret their provisions, and enforce them by awarding damages. *Canada* is therefore controlling, and we must hold that plaintiffs' claims trigger the revenue rule and are barred unless plaintiffs establish that Congress has abrogated the revenue rule as it applies to the circumstances of this case.

Plaintiffs argue that, even though *Canada* held that RICO does not abrogate the revenue rule, the recent amendments to RICO passed as part of the Patriot Act in October 2001 demonstrate Congress's intent to abrogate the rule. The crux of plaintiffs' argument, both on appeal and below, is that the addition of several money laundering crimes to RICO's predicate acts evinces Congress's understanding that the purpose of RICO is to prevent precisely the conduct alleged here, and the legislative history of the amendments, particularly Congress's deletion from the draft statute of an amendment that would have codified the *Canada* holding, provides clear evidence of Congress's intent to abrogate the rule.

Plaintiffs first focus on the text of the Patriot Act's amendments to RICO, contending that the addition of several international money laundering predicate offenses, such as money laundering crimes against foreign nations and financial conduct that aids terrorist groups, reflects congressional intent to abrogate the revenue rule. *See* 18 U.S.C. § 1956(c)(7). We disagree. The Patriot Act did not change the structure or focus of RICO; it simply added additional offenses to those that constitute predicate acts of racketeering. While we stated in *Canada* that the presumption against statutory derogation of the common law does not apply when "a statutory purpose to the contrary is evident," *Canada*, 268 F.3d at 127 (internal citation omitted), the recent additions to RICO have not so altered RICO's statutory scheme or apparent purpose as to warrant our revisiting *Canada* 's conclusion that RICO does not abrogate the revenue rule. Plaintiffs may be correct that the RICO amendments contained in the Patriot Act are designed to combat precisely the conduct alleged here; but the conduct alleged in *Canada* was also within the scope of RICO's prohibitions, *see id.* at 106-08. Because *Canada* holds that the operation of the rule does not depend on the type of conduct alleged, but rather on the substance of the relief sought, the foreign policy concerns raised by the suit, and the identity of the plaintiffs, a mere showing that the plaintiffs' suit will further the policies embodied in the statute at issue is not sufficient to abrogate the rule. Rather, the statute must provide clear evidence, textual or otherwise, that Congress believes that the revenue rule should not apply. *Id.* at 128.

Plaintiffs further argue that Congress provided the necessary evidence of congressional intent to abrogate the revenue rule by deleting a provision in the initial version of the Act that would have stated that the addition of the money laundering offenses did not expand the jurisdiction of the courts to hear claims based on foreign excise taxes. The section of the Act that added new international money laundering offenses to RICO's list of predicate acts, *see* 18 U.S.C. §§ 1956, 1961(1), initially provided that the amendments were subject to the following rule of construction:

> (b) RULE OF CONSTRUCTION.–None of the changes or amendments made by the Financial Anti-Terrorism Act of 2001 shall expand the jurisdiction of any Federal or State court over any civil action or claim for monetary damages for the nonpayment of taxes or

> duties under the revenue laws of a foreign state, or any political subdivision thereof, except as such actions or claims are authorized by [a] United States treaty that provides the United States and its political subdivisions with reciprocal rights to pursue such actions or claims in the courts of the foreign state and its political subdivisions.

Financial Anti-Terrorism Act of 2001, H.R. 3004, 107th Cong. § 106(b).[5] This provision was deleted from subsequent versions of the Act, however; as the October 23, 2001 section-by-section analysis of the Act notes, the House of Representatives "dropped [the] provision carving out tobacco companies from RICO liability for foreign excise taxes." 147 Cong. Rec. H7198 (daily ed. Oct. 23, 2001). In addition, several individual legislators indicated their opposition to the rule of construction after it was dropped from the bill. . . . Plaintiffs argue that the omission of this provision from the enacted text of the Act, as well as the statements by individual legislators indicating opposition to the provision, provide the clear evidence of congressional intent necessary to abrogate the revenue rule.

As an initial matter, plaintiffs have provided no evidence that the deletion of the rule of construction has any effect on the meaning of the Act's amendments to RICO. In deleting the rule of construction that would have codified *Canada* 's holding, Congress left the enacted text of RICO just as silent on the issue of abrogation as it was when *Canada* was decided. Moreover, the absence of the rule of construction does not add any meaning to the text of the new predicate offenses, or suggest that those amendments are in any way meant to abrogate the revenue rule. We cannot find clear evidence of congressional intent to overrule *Canada* and abrogate the revenue rule as it applies to RICO suits from legislative history that is not related to any actual amendment to RICO. *See Shannon v. United States*, 512 U.S. 573, 583 (1994) (noting that courts do not give "authoritative weight" to elements of the legislative history that are "in no way anchored in the text of the statute").

Nonetheless, plaintiffs assert a number of arguments in an attempt to establish that the legislative history alone compels us to find congressional intent to abrogate the revenue rule. They first contend that the deletion itself is sufficient evidence of legislative intent to abrogate the rule, relying on the Supreme Court's statement, in the context of interpreting a term within a RICO provision, that "[w]here Congress includes limiting language in an earlier version of a bill but deletes it prior to enactment, it may be presumed that the limitation was not intended." *Russello v. United States*, 464 U.S. 16, 23-24 (1983) (interpreting the word "interest" in the context of RICO's enterprise provisions). While this rule of construction is helpful in giving meaning to a particular term or phrase contained within a statutory provision, it may not be used to effectively amend a statute where Congress has not actually altered its enacted text. The mere deletion of the provision is a far more ambiguous act than plaintiffs suggest, because Congress's reluctance to codify *Canada*'s holding does not necessarily reflect its desire to overrule that holding. "[F]ailed legislative proposals are a particularly dangerous ground on which to rest an interpretation of a prior statute," as "congressional inaction lacks persuasive significance because several equally tenable inferences may be drawn from such inaction, including the inference that the existing legislation already incorporated the offered change." *United States v. Craft*, 535 U.S. 274, 287 (2002) (internal quotation marks and citations omitted). This is particularly the case here, where

5. The Financial Anti-Terrorism Act of 2001 was later subsumed into the Patriot Act. *See* 147 Cong. Rec. H7198 (daily ed. Oct. 23, 2001).

the proposed amendment simply would have codified the revenue rule as it was explicated in *Canada,* and would not have effected any change in the law. Thus, the deletion alone, untethered to the actual enactment, cannot provide a basis upon which to infer any congressional intent to abrogate the revenue rule, much less the clear evidence required by our holding in *Canada.*

Plaintiffs contend, however, that the statements of several legislators to the effect that foreign nations should be able to use RICO to impose liability on domestic companies for foreign excise taxes indicate that the provision was deleted because Congress intended to abrogate the rule. Several legislators clearly disagreed with the revenue rule, and made remarks to this effect. *See* 147 Cong. Rec. E1936 (daily ed. Oct. 29, 2001) (statement of Rep. Wexler) ("I am pleased that a provision earlier included ... which would have inhibited RICO liability for foreign excise taxes for tobacco companies, has been dropped from the USA PATRIOT Act ...."); *id.* at H7205 (daily ed. Oct. 23, 2001) (statement of Rep. Conyers) ("I am very proud [that] we dropped the administration proposal ... that would have ... prevented RICO liability for tobacco companies ...."); *id.* at S11028 (daily ed. Oct. 25, 2001) (statement of Sen. Kerry) ("The House-passed rule of construction could have potentially limited the access of foreign jurisdictions to our courts ...."); *id.* at S11007 (daily ed. Oct. 25, 2001) (statement of Sen. Leahy) (stating that Congress had eliminated the "carve-out of tobacco companies from RICO liability for foreign excise taxes"). None of these statements represent the "collective understanding" of the committees responsible for the Act,[6] however, and they are therefore not entitled to very much weight. *See United States v. Nelson,* 277 F.3d 164, 186-87 (2d Cir.2002), *cert. denied,* 537 U.S. 835 (2002) ("We ... 'eschew [ ] reliance on the passing comments of one Member, and casual statements from the floor debates.' ") (quoting *Garcia v. United States,* 469 U.S. 70, 76 (1984)). Because the legislative record does not suggest anything other than that a few individual legislators wished to abrogate the revenue rule, those legislators' statements do not render the deletion of the proposed rule of construction unambiguous, or provide adequate insight into that deletion. Taken as a whole, the legislative history does not provide clear evidence that Congress intended to abrogate the revenue rule when it enacted the Patriot Act.

Plaintiffs next argue, in the alternative, that the legislative history of the Patriot Act constitutes persuasive post-enactment evidence that Congress intended RICO, as enacted in 1970, to abrogate the revenue rule. This is, in essence, an invitation to revisit *Canada*'s holding that RICO, as it then existed, did not abrogate the revenue rule, in light of the statements made in relation to the proposed rule of construction. The Patriot Act's legislative history, however, does not provide clear evidence of any congressional understanding that RICO has always abrogated the revenue rule. First, the individual legislators' comments indicate, at most, a reluctance to enact the common law revenue rule into the statutory text. They do not explicitly or implicitly express the view that RICO itself abrogates the revenue rule, and we are unwilling to infer this belief from a few passing statements commenting on a provision that had already been removed from the text of the Patriot Act. Second, as noted above, the isolated statements of individual legislators do not express the intent of Congress as a whole, and are therefore weak evidence of post-enactment intent. Third, expressions of legislative intent made years after the statute's initial enactment are entitled to limited weight under any circum-

6. Although plaintiffs refer to the section-by-section analysis of the Act inserted into the legislative record by Senator Leahy as the "Senate's [R]eport," *see* 147 Cong. Rec. S11007 (daily ed. Oct. 25, 2001), there is no Senate Report on the Patriot Act. The analysis is simply Senator Leahy's own discussion of the provisions of the Act. *See id.* at S10990 (Oct. 25, 2001).

stances, even when the post-enactment views of Congress as a whole are evident. *See United States v. Southwestern Cable Co.,* 392 U.S. 157, 170 (1968) ("[T]he views of one Congress as to the construction of a statute adopted many years before by another Congress have very little, if any, significance.") (internal quotation marks omitted). Thus, these statements do not convince us that *Canada* wrongly concluded that the 91st Congress did not intend to abrogate the revenue rule when it enacted RICO.

We do not hold that a statute's legislative history may never contain sufficient indicia of congressional intent to find that the statute abrogates the revenue rule. *Cf. Canada,* 268 F.3d at 129 (noting that a statute's legislative history and purpose, as well as its text, may be relevant to the inquiry into whether it abrogates the revenue rule). Here, however, the purported evidence of intent to abrogate on which plaintiffs rely is particularly weak. We cannot find that a few remarks in the legislative history of the recent amendments to RICO, and the deletion of a provision that would have codified *Canada,* have altered the statute itself, or provided a reliable indicator of congressional intent in the absence of an actual enactment. Were we to treat Congress's decision not to enact the proposed rule of construction as an explicit abrogation of the revenue rule, we would be privileging the legislative history of the Patriot Act over its enacted language. To do so would turn on its head the rule that any analysis of a statute and Congress's intent in enacting it must primarily be founded in the text of the statute itself. *See Shannon,* 512 U.S. at 583 ("To give effect to this snippet of legislative history, we would have to abandon altogether the text of the statute as a guide in the interpretative process.").

C. Plaintiffs' Remaining Attempts to Distinguish *Canada*

Plaintiffs also attempt to distinguish their claims from those at issue in *Canada* by arguing that the foreign policy concerns necessary to trigger the revenue rule are not present here. All of these arguments are foreclosed by *Canada,* however, and do not change our conclusion that the revenue rule is implicated by plaintiffs' claims.

First, plaintiffs argue that the several treaties of friendship between the United States and EC member states indicate that the political branches intend to provide foreign nations with unlimited access to domestic courts.[7] This contention is simply an attempt to reargue *Canada,* which examined the tax treaties currently in force between the United States and various nations, *Canada,* 268 F.3d at 115-22, and concluded that the revenue rule remains "fully consistent with our broader legal, diplomatic, and institutional framework," *id.* at 119. Plaintiffs have not proffered any evidence of a shift in United States policy with respect to tax treaties and enforcement assistance since our decision in *Canada,* and thus we cannot conclude that the political branches now intend to provide judicial tax enforcement assistance to other nations.

Second, plaintiffs contend that, even though the landscape of treaties has not changed

7. The Palermo Convention of 2000, Vienna Convention of 1988, and Joint European Union-United States Ministerial Statement on Combating Terrorism (2001) all express a policy of cooperation and reciprocal access to foreign and domestic courts in order to combat organized crime and terrorism. *See The United Nations Convention Against Transnational Organized Crime, opened for signature* Dec. 12, 2000, 40 I.L.M. 335 (unratified by the United States); *United Nations Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances,* Dec. 20, 1988, S. Treaty Doc. No. 101-4 (entered into force Nov. 11, 1990); *Joint EU-US Ministerial Statement on Combating Terrorism,* Sept. 20, 2001, 40 I.L.M. 1263. In *Canada,* however, we implicitly acknowledged that foreign sovereigns have long had access to United States courts, and may sue for violations of domestic laws, *see Canada,* 268 F.3d at 123, but because the revenue rule has reflected the reluctance of the United States and many other nations to enforce foreign tax laws for two hundred years, *id.* at 110, we looked to our nation's tax treaties, rather than treaties that simply provide general access to courts, to determine whether the political branches' actions indicated an abandonment of the rule. Thus, the treaties that plaintiffs cite are not particularly relevant to whether the revenue rule should apply here.

since our decision in *Canada*, the executive branch has indicated its consent to this suit, obviating the separation of powers and sovereignty concerns that trigger the rule. The United States has not intervened in opposition to this suit, despite its purported knowledge of the action, and plaintiffs argue that this "neutrality" evidences the United States's judgment that this lawsuit is not antithetical to United States foreign policy interests. We, however, require more than executive inaction in order to find consent to the suit. Rather, the executive branch must affirmatively "express its consent" or approval, for instance, by bringing suit itself. *Id.* at 123 & n. 25. Because the political branches have chosen to negotiate treaties providing for only limited reciprocal tax enforcement assistance to other nations, *see id.* at 115-22, absent affirmative consent to a suit by the executive branch, we must assume that a lawsuit seeking general extraterritorial enforcement of foreign tax laws exceeds the bounds of the assistance that the executive branch has decided to give. Moreover, were executive inaction sufficient to render the revenue rule inoperative in a given case, the United States would be required to intervene in every case that might implicate the revenue rule. Such a proposition is clearly untenable.

Third, plaintiffs attempt to distinguish their claims by focusing on their requests for injunctive relief, arguing that "[i]njunctive relief to enjoin or abate conduct on U.S. soil does not involve foreign tax law in any way." Adjudicating plaintiffs' entitlement to injunctive relief, however, would require the court to evaluate and interpret foreign tax laws. Moreover, the requested injunctions would have the effect of extraterritorially enforcing plaintiffs' tax laws just as directly as would their claims for damages, as plaintiffs would have the court order the defendants to cease their smuggling operations, disgorge their profits, and put into place measures that would allow foreign customs officials to ensure that they are complying with those nations' revenue laws. Thus, the requested relief, though different in form, has the same implications as plaintiffs' claims for damages, and is barred by the revenue rule. *See id.* at 131.

Finally, plaintiffs argue that even if their claims implicate the revenue rule, it is a discretionary doctrine that, when triggered, allows the district court to consider the foreign relations implications and domestic law enforcement interests at stake before deciding whether to "abstain" from hearing the claims. This argument is also foreclosed by *Canada,* which clearly establishes that, once the sovereignty and separation of powers concerns that inform the rule are implicated by the substance of a plaintiff's claims, the court may not hear those claims absent evidence that the rule has been abrogated. *Id.* at 113. Thus, the district court did not misconstrue the nature of the rule. . . .

NOTES AND QUESTIONS

1. In *RJR Nabisco*, the plaintiffs' primary argument is that the *Canada* case is abrogated by the USA PATRIOT Act and its amendment of RICO. Do you find this argument persuasive? What is the court's problem with this argument?

2. Based on the discussion in *RJR Nabisco*, what is the motivating theme behind the revenue rule? The plaintiffs argue that the rule is subject to judicial discretion. Historically, the rule seems to have been based on the "pragmatic desire of eighteenth-century English judges to promote 'British trade. . .' ." In the *Canada* case, the Second Circuit said the rule "reflects both sovereignty and separation of powers concerns. So, which is it?

3. How would the *Banco Frances* court have decided *RJR Nabisco*?

4. Perhaps without realizing it, the courts have stated two inconsistent principles for the situation when the situs is no longer foreign. Suppose the foreign government enacts an exchange control rule that freezes deposits in local branches of foreign hanks–the *Banco Frances* principle calls on foreign courts to honor that rule; the *Vishipco-Garcia* rule calls on them to dishonor it. Yet, this is precisely the situation posed in some of the emergency regulations issued in response to the debt crisis. And the situation of a nation refusing to honor its debts poses much the same policy issue. *Weston,* the case after *Vishipco,* shows the difficulty the courts have with the conflict. For another example see *Libra Bank v, Banco Nacional de Costa Rica,* 570 F. Supp. 870 (S.D.N.Y. 1983).

VISHIPCO LINE v. CHASE MANHATTAN BANK

660 F.2d 854 (2d Cir. 1981), *cert. denied*, 459 U.S. 976 (1982)

MANSFIELD, J.

Plaintiffs appeal from a judgment . . . dismissing their claims against Chase Manhattan Bank, N.A. ("Chase"), for breach of contract. The ten corporate plaintiffs . . . are Vietnamese corporations which maintained piastre demand deposit accounts at Chase's Saigon branch in 1975. . . . [T]hey claim that Chase breached its deposit contracts with them when it closed the doors of its Saigon branch on April 24, 1975, to escape from the Communist insurgents and subsequently refused to make payment in New York of the amount owed. The individual plaintiff–Ms. Nguyen Thi Cham–is a Vietnamese citizen who purchased a six-month two hundred million piastre certificate of deposit ("CD") from Chase's Saigon branch on November 27, 1974, and claims that Chase is in breach for refusing to cash the CD in dollars in New York.

. . . Chase was clearly obligated to pay plaintiffs the amounts it owed them. None of the affirmative defenses raised by Chase to its conceded obligations to plaintiffs can be sustained. . . . The present worthlessness of the South Vietnamese piastre is no barrier to recovery. Under New York law which governs, the dollar value of Chase's obligation to the corporate plaintiffs must be determined as of the date when it closed its branch without giving them the opportunity to withdraw sums owed then rather than the date of judgment. The individual plaintiff, Ms. Cham, is entitled to recover the value in dollars of her CD on its due date.

From 1966 until April 24, 1975, Chase operated a branch office in Saigon. . . . Chase's operations in Saigon came to an end at noon on April 24, 1975, after Chase officials in New York determined that Saigon would soon fall to the Communists. After closing the branch without any prior notice to depositors, local Chase officials balanced the day's books, shut the vaults and the building itself, and delivered keys and financial records needed to operate the branch to personnel at the French Embassy in Saigon. Saigon fell on April 30th, and on May 1st the new government issued a communique which read as follows:

> All public offices, public organs, barracks, industrial, agricultural and commercial establishments, banks, communications and transport, cultural, educational and health establishments, warehouses, and so forth–together with documents, files, property and technical means of U.S. imperialism and the Saigon administration–will be confiscated and, from now on, managed by the revolutionary administration.

Shortly thereafter, the French embassy turned over records from the Chase branch to the new government. . . .

Chase . . . argues that the Vietnamese decree confiscating the assets which maritime corporations such as the corporate plaintiffs had left behind had the effect of seizing the piastre deposits at issue in this case. As a result, according to Chase, the corporate plaintiffs may not sue to recover the deposits because they no longer own them, and the act of state doctrine bars any challenge to the validity of the governmental seizure. We disagree. There is no evidence that plaintiffs' existence as corporate entities was terminated. Moreover, it is only by way of a strained reading of the Vietnamese confiscation announcement that one can even argue that choses in action were meant to be included. The plain meaning of the statement that "the Saigon-Gia Dinh Management Committee quickly took over the management of all maritime transportation facilities abandoned by their owners" is that the seizures involved physical assets only and did not reach whatever claim the corporate plaintiffs might have on their departure for payment of the amounts owed to them by Chase.

More importantly, however, upon Chase's departure from Vietnam the deposits no longer had their situs in Vietnam at the time of the confiscation decreed. As we have said in the past, "[f]or purposes of the act of state doctrine, a debt is not 'located' within a foreign state unless that state has the power to enforce or collect it." *Menendez v. Saks and Co.*, 485 F.2d 1355, 1364 (2d Cir. 1973), *rev'd on other grounds sub nom. Alfred Dunhill of London, Inc. v. Republic of Cuba*, 425 U.S. 682 (1976). The rule announced in *Harris v. Balk*, 198 U.S. 215 (1905), continues to be valid on this point: the power to enforce payment of a debt depends on jurisdiction over the debtor. Since Chase had abandoned its Saigon branch at the time of the Vietnamese decree, and since it had no separate corporate identity in Vietnam which would remain in existence after its departure, the Vietnamese decree could not have had any effect on its debt to the corporate plaintiffs. As one qualified commentator has observed:

> The situs of a bank's debt on a deposit is considered to be at the branch where the deposit is carried, but then if the branch is closed, . . . the depositor has a claim against the home office; thus, the situs of the debt represented by the deposit would spring back and cling to the home office. If the situs of the debt ceased to be within the territorial jurisdiction of [the confiscating state] from the time the branch was closed, then at the time the confiscatory decree was promulgated, [the confiscating state would] no longer [have] sufficient jurisdiction over it to affect it . . . [U]nder the act of state doctrine, the courts of the United States are not bound to give effect to foreign acts of state as to property outside the acting state's territorial jurisdiction. Heininger, *Liability of U.S. Banks for Deposits Placed in Their Foreign Branches*, 11 LAW & POL. INTL. BUS. 903, 975 (1979) (footnotes omitted) ("Heininger").

These principles have been recognized in New York. *See Manas y Pineiro v. Chase Manhattan Bank, N.A.*, 106 Misc.2d 660, 434 N.Y.S.2d 868 (Sup. Ct. N.Y. Cty. 1980), where the court held that for the purpose of the act of state doctrine the situs of a debt depends on whether the parties and the *res* were in the foreign country at the time of confiscation. Since in our case Chase's branch in Saigon was neither open nor operating at the time of the confiscation and had in fact been abandoned prior to that time, the Vietnamese decree was ineffective as against Chase's debt to the plaintiffs. . . .

Chase next argues that under Vietnamese law its failure to repay plaintiffs' deposits in the period prior to May 1, 1975, was not a breach of its deposit contract, because the conditions prevailing in Saigon at the time rendered payment impossible. . . .

This argument must be rejected for the reasons that impossibility of performance in

Vietnam did not relieve Chase of its obligation to perform elsewhere. By operating in Saigon through a branch rather than through a separate corporate entity, Chase accepted the risk that it would be liable elsewhere for obligations incurred by its branch. As the official referee in the *Sokoloff* case (Harrison Tweed, of the Milbank Tweed firm) summarized the law:

> [W]hen considered with relation to the parent bank, [foreign branches] are not independent agencies; they are, what their name imports, merely branches, and are subject to the supervision and control of the parent bank, and are instrumentalities whereby the parent bank carries on its business . . . *Ultimate liability for a debt of a branch would rest upon the parent bank*. *Sokoloff v. National City Bank*, 130 Misc. 66, 224 N.Y.S. 102, 114 (Sup. Ct. N.Y. Cty. 1927) (emphasis added).

U.S. banks, by operating abroad through branches rather than through subsidiaries, reassure foreign depositors that their deposits will be safer with them than they would be in a locally incorporated bank. . . . Indeed, the national policy in South Vietnam, where foreign banks were permitted to operate only through branches, was to enable those depositing in foreign branches to gain more protection than they would have received had their money been deposited in locally incorporated subsidiaries of foreign banks. Chase's defenses of impossibility and force majeure might have succeeded if the Saigon branch had been locally incorporated or (more problematically) if the deposit contract had included an explicit waiver on the part of the depositor of any right to proceed against the home office. But absent such circumstances the Saigon branch's admitted inability to perform did not relieve the Chase of liability on its debts in Saigon, since the conditions in Saigon were no bar to performance in New York or at other points outside of Vietnam. Nor has Chase shown that the Vietnamese government took steps to assume or cancel its branch liabilities. The May 1st decree nationalizing the Vietnamese banking industry only provided that "[a]ll . . . banks . . . will be confiscated and from now on managed by the revolutionary administration." In addition, during discovery Chase, in response to the following interrogatory:

> "Interrogatory 4. When the assets were seized did the Government of Vietnam agree to pay the depositors at the Saigon branch?"

replied:

> "Chase lacks the knowledge necessary to answer this interrogatory."

The evidence therefore can only be read as showing that the Vietnamese government confiscated the assets abandoned by Chase in Saigon, but did not thereby affect Chase's liabilities to its depositors. Under these circumstances, Justice (then Judge) Cardozo's opinion in *Sokoloff* fifty years ago applies:

> The defendant's liability was unaffected by the attempt to terminate its existence and the seizure of its assets. . . . Plaintiff did not pay his money to the defendant, and become the owner of this chose in action, upon the security of the Russian assets. He paid his money to a corporation organized under our laws upon the security of all its assets, here as well as elsewhere. Everything in Russia might have been destroyed by fire or flood, by war or revolution, and still the defendant would have remained bound by its engagement. *Sokoloff v. National City Bank*, 239 N.Y. 158, 167, 145 N.E. 917 (1924).

As one commentator has summarized the law:

> The defenses of frustration and impossibility were . . . rejected at an early stage in the *Sokoloff* proceedings, and do not appear to have been successfully raised in subsequent cases involving foreign branches of U.S. banks. Rather, the well established path from branch to home office has been followed, even if the branch has been closed, to establish an alternative means for performance. Heininger, *supra*, at 1003-04.

A bank which accepts deposits at a foreign branch becomes a debtor, not a bailee, with respect to its depositors. In the event that unsettled local conditions require it to cease operations, it should inform its depositors of the date when its branch will close and give them the opportunity to withdraw their deposits or, if conditions prevent such steps, enable them to obtain payment at an alternative locations. *See, e.g., Sokoloff v. National City Bank*, *supra*, 130 Misc. at 71, 224 N.Y.S. at 112; Heininger, *supra*, at 1009-10. In the rare event that such measures are either impossible or only partially successful, fairness dictates that the parent bank be liable for those deposits which it was unable to return abroad. To hold otherwise would be to undermine the seriousness of its obligations to its depositors and under some circumstances (not necessarily present here) to gain a windfall.

Chase's next argument, that under New York law its non-payment must be excused because no demand was ever made prior to the closing of its Saigon branch, must also be rejected. No Vietnamese law was offered on this issue. Nor is Chase's contention supported by New York law. It is not settled that a demand is not necessary where the branch in which the deposit was maintained (or by which the CD was issued) has been closed. . . . *Sokoloff v. National City Bank*, 250 N.Y. 69, 80-81, 164 N.E. 745 (1928) (where Petrograd branch of National City Bank ceased to exist because of Soviet seizure, this made "demand useless and unnecessary" and no demand was required since it "would manifestly be futile"). Similarly, reliance on New York cases suspending or excusing performance during times of war fails, since Chase, which was ultimately liable for the debt, was never barred by the wartime conditions in Vietnam from making payment outside of Vietnam. Finally, Chase, as a national bank, can find no comfort in the provisions of § 138 of the New York Banking Law, which purport to limit in various ways the liability of *state* bank and trust companies for deposits made in overseas branches. By its own terms, § 138 is unavailable to Chase in this case, because it only applies to state, not national, banks. If this unavailability has the effect of placing national banks like Chase at a competitive disadvantage vis-à-vis state banks, as Chase alleges, the solution lies with Congress, not the judiciary.

Chase argues that, even if all its other affirmative defenses fail, plaintiffs cannot recover because the judgment-day rule, under which obligations to pay foreign currencies (in this case piastres) must be converted prior to payment into dollars at the rate of exchange prevailing on the day judgment is entered, applies to this case and precludes any recovery, since the piastre is now worthless. We disagree. As a federal court sitting in diversity, we must apply the currency-conversion rule employed by the courts of New York, which has followed the breach-day rule for many years. Therefore, plaintiffs are entitled to recover an amount in dollars which reflects the exchange rate between dollars and South Vietnamese piastres at the time of breach, plus statutory interest.

It is true that federal courts sitting in *non*-diversity cases have rather consistently adopted the judgment-day rule. . . . However, this rule is substantive rather than procedural (there is no Federal Rule of Procedure on the subject) and therefore cannot be followed by federal courts sitting in diversity in states which apply the breach-day rule. *See generally Compania Engraw Commercial E. Industrial S.A. v. Schenley Distillers Corp.*, 181 F.2d 876, 879 (9th Cir. 1950). Absent a federal rule, *see* Ely, *The Irrepressible Myth of Erie*, 87 Harv.L.Rev. 693, 698 (1974), the choice between conflicting state and federal practice must be made with a view toward fulfilling "the twin aims of the *Erie* rule: discouragement of forum-shopping and avoidance of in-equitable administration of the laws." *Hanna v. Plumer*, 380 U.S. 460, 468 (1968). ...

WESTON BANKING CORP. V. TURKIYE GARANTI BANKASI, A.S.

57 N.Y.2d 315, 442 N.E.2d 1195 (1982)

JASEN, J.

On this appeal, we are asked to decide whether, in light of the Act of State doctrine and the Bretton Woods Agreement, a Panamanian bank can maintain an action in this State against a Turkish bank on the basis of a promissory note that designates New York as the proper jurisdiction for resolution of any disputes. A secondary issue presented by this appeal is whether there was proper service of process on the defendant.

The promissory note which plaintiff, Weston Banking Corporation, a Panamanian banking corporation, seeks to enforce was signed by representatives of the defendant on July 9, 1976 in Istanbul, Turkey. Pursuant to its terms, defendant bank undertook an obligation to repay plaintiff principal in the amount of 500,000 Swiss francs, plus interest calculated at 9% per annum. The interest was to be paid semiannually and the principal was due on ,july 9 1979. The note also provided that: “Payment of principal and interest shall he made at the offices of the CHEMICAL BANK . . . New York City, New York, U.S.A., by means of a cable transfer to Switzerland in Lawful currency of the Swiss Federation.” Such payments were to be “made clear of all restrictions of whatsoever nature imposed thereon by, outside of bilateral or multilateral payment agreements or clearing agreements which may exist at the time of payment and free and clear of and without deductions for any taxes, levies, imposts, deductions . . . imposed . . . by the Republic of Turkey”.

Under the terms of the note, the defendant designated Chemical Bank, International Division, New York City, as its legal domicile and accepted the jurisdiction of New York courts “in the event of Judicial or extrajudicial [*sic*] claim or summons of any nature”. The holder was also given the option to bring suit against the maker in the Turkish courts. The final paragraph of the note indicates that the note “is issued under communique number 164, published by the Ministry of Finance.”

Communique No. 164 amended Decree No. 17 of the Turkish Ministry of Finance. The decrees allow banks in Turkey to open convertible Turkish lira deposit accounts (CTLDs) when the bank obtains foreign currency by borrowing or through deposits. The bank is required under Turkish law to transfer the foreign currency to the Central Bank of Turkey. The Central Bank credits the privately owned bank with the equivalent amount of Turkish lira. These amounts are then available for investment by the banks. This program was apparently designed to encourage Turkish banks to seek foreign investments to help stabilize the Turkish balance of payments by making available to the Turkish government more foreign currency. The banks benefited because the Turkish government covered any costs incurred by a fluctuation in the exchange rates between the currencies.

In July, 1976, the defendant Turkish bank borrowed 500,000 Swiss francs from the plaintiff bank and used these funds to establish a CTLD. As the interest became due, payments were made in Swiss francs at Chemical Bank's International Division in New York City. However, when the note was presented for payment in July, 1979, defendant refused to pay the principal on the ground that the then existing Turkish banking regulations barred it from paying back the loan in Swiss francs.

It is not disputed that the defendant failed to pay the principal amount due plaintiff Nor is the validity of the underlying note disputed. The heart of the defenses raised is that Turkish monetary regulations enacted subsequent to the date of the note make it legally impossible for the defendant bank to repay the loan in Swiss francs and that plaintiff's only "recourse is to be repaid in Turkish lira." Furthermore, the defendant contends that the promulgation of this regulation is an act of State and as such is beyond the review of New York courts. Similarly, defendant argues that the policy of the United States, as incorporated in the Bretton Woods Agreement (U.S. Code, tit. 22, §286; 59 U.S. Stat 512; 60 U.S. Stat 1411), is to refrain from any interference with the monetary regulations of signatory countries. . . .

Turning then to the facts of this case, we must determine whether the note and the regulation which defendant contends restricts the repayment of the promissory note require application of the Act of State doctrine. The note was executed in Istanbul, Turkey, and states that it is "issued under communique number 164" of the Turkish Ministry of Finance. Defendant contends that this makes the note subject to all Turkish monetary controls, even those enacted subsequent to the date of the note. Plaintiff, on the other hand, points out that Communique No. 164 merely authorizes Turkish banks to engage in this type of transaction arid that the note specifies that repayment is not subject to regulation by the Turkish government. We would add that the note requires payment to be made at Chemical Bank in New York City and designates New York law to be controlling.

We conclude that on these facts the Act of State doctrine does not constitute a defense to plaintiff's action to recover on this note. A debt is not located within a foreign State unless it has the power at the instance of an interested party to enforce or collect it. (*Zeevi & Sons v. Grindlays Bank [Uganda]*, 37 N.Y.2d 220, 228, 371 NN.S.2d 892 (1975), *cert. denied*, 423 U.S. 866 (1975); *Republic of Iraq v. First Nat'l. City Bank*, 353 F.2d 47, 51 (2d Cir. 1965), *cert. denied*, 382 U.S. 1027 (1966)). Here, the debt is equally capable of being enforced against the defendant's assets in New York as it is capable of being enforced against its assets in Turkey, and the State of Turkey has no power to enforce collection of this debt. The mere fact that this suit might have been commenced in Turkey, instead of New York, does not bar the action. Indeed, the note provides that New York shall be the proper jurisdiction for dispute resolution. Such a provision naturally contemplates enforcement of any judgment which would resolve the dispute. Thus, the Act of State doctrine does not bar this action.

Whether or not extraterritorial effect will be given to the Turkish regulation depends on whether it controls the issue presented to this court and whether it is consistent with the policies of this State. *(Zeevi & Sons v. Grindlays Bank [Uganda], supra,* 37 NY2d at pp. 227-228, 371 N.Y. S.2d 892, 333 N.E.2d 168; *Republic of Iraq v. First Nat'l City Bank, supra,* at p. 51.) The initial inquiry must be to ask what the regulation provides.

Defendant has provided the court with translated and certified copies of all pertinent Turkish law and plaintiff has raised no claim concerning the propriety of these documents. Our reading of those regulations, whether individually or as representative of a continuous Turkish monetary policy, indicates that there is no per se ban imposed on all Turkish banks preventing them from paying this type of promissory note with foreign currency. The record indicates that the directive of the Ministry of Finance does not bar payment of the note, but, rather, establishes a program under which CTLDs could be restructured through the Turkish Central Bank. Defendant's own counsel in responding to plaintiff's inquiry about the effect of the restructuring program stated: "The Central Bank is obligated to pay interest only after CTLDS are included in the restructuring under the CTLD Credit Agreement. All CTLDs not included in the restructuring will remain obligations of the commercial banks in Turkey with which they are made." Plaintiff denies ever agreeing to have this note included in the restructuring program. Defendant makes no claim and offers no proof to the contrary; in fact, the record is devoid of any indication that the regulations on which defendant relies are applicable to this note.

Thus, we need not reach the question of whether these regulations comport with this State's policy so that they should be given extraterritorial application. It is sufficient to note that defendant has failed to introduce any documentation to support its contention that Turkish law forbids the payment of a promissory note designating that payment shall be made in Swiss francs at a hank incorporated in the United States.

This failure of proof also reaches to the validity of defendant's claim that the Bretton Woods Agreement bars this action. The Bretton Woods Agreement (U.S. Code, tit. 22, §286; 59 U.S. Stat 512; 60 U.S. Stat 1411) is an international treaty to which both the United States and Turkey are signatories. The purpose of the Agreement, as stated in article 1 (60 U.S. Stat 1401), is to promote international monetary co-operation, exchange stability and "[t]o assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade." (Art I. [iv].)

The defendant relies on article VIII (§2, subd. [b]) of the Agreement as a defense to this action, which provides that "[e]xchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member." This article renders unenforceable any agreement involving the currency of a member State which is contrary to "that member's" currency control regulations. The promissory note involved here obligated the defendant to repay the plaintiff the principal sum loaned in Swiss francs and not Turkish lira.

Were the currency regulations to ban payment in foreign currencies when a CTLD was liquidated, a different case would have been presented. In this case, however, the regulation merely permits a Turkish bank to restructure the debt. As we previously stated, there is no proof, in this record, that if the debt were not restructured, the bank would be barred from repaying the plaintiff in Swiss francs as required by the terms of the note. Therefore, although we recognize the validity of the Bretton Woods Agreement and its potential controlling effect over international currency transactions, on the record before us, we do not find it to be applicable. . . .

MEYER, J. (dissenting).

The International Monetary Fund (Bretton Woods) Agreement of 1945 (60 U.S. Stat 1401, TIAS 1501) to which the United States and Turkey are signatories, the mandate of section 11 of the Bretton Woods Agreements Act (59 U.S. Stat 516; U.S. Code, tit. 22, §286h) that "the first sentence of article VIII, section 2(b), of the Articles of Agreement of the Fund . . . shall have full force and effect in the United States", the legislative history of that Congressional enactment, the supremacy clause of the United States Constitution, and the decision of the United States Supreme Court in *Kolovrat v. Oregon*, 366 U.S. 187 establish beyond peradventure that the applicability of the first sentence of article VIII (§2, subd. [b]) presents a question of Federal not State law. ...

If article VIII (§2, subd. [b]) applies, neither the Act of State doctrine referred to by the majority and the Appellate Division nor the intention of the parties to free it from Turkish regulation, relied upon by the Appellate Division, are relevant. The starting point for analysis is rather the Appellate Division's statement (86 AD2d 544, 545, 446 N.Y.S.2d 67) that "Communique No. 164, under which the note was issued, imposes no conditions on repayment; it simply authorizes issuance of a note payable in foreign currency" and the statement of the majority in this court (pp. 325-326, 456 N.Y.S.2d 688, 442 N.E.2d 1199) "that defendant has failed to introduce any documentation to support its contention that Turkish law forbids the payment of a promissory note designating that payment shall be made in Swiss francs at a bank incorporated in the United States." Does the record bear out those conclusions? . . .

[Judge Meyer concluded that Turkish law did forbid the payment, and that the contract was an exchange contract involving Turkish currency.]

Because . . . the note in suit is governed by Turkish regulations and the Bretton Woods Agreement and the Bretton Woods Agreements Act proscribe enforcement of the note by the courts of this State in contravention of those regulations, I would grant defendant's cross motion for summary judgment dismissing the complaint.

NOTES AND QUESTIONS

1. Why isn't *Vishipco* governed by Article VIII(2)(b) of the IMF Charter?

2. Note that the Milbank Tweed firm, which represented Vishipco, had also been involved in the *Sokoloff* case cited by the court, Did this hurt its position? What could it have done?

3. Should a U.S. court ever issue judgments in foreign currency?

4. Does *Vishipco* give a lucky few a way to evade foreign exchange controls?

5. Suppose that it were clear in *Weston* that the Turkish laws were meant to be applicable and mandatory. Would you decide the case the way Judge Meyer urges? What are the arguments and possible approaches either way?

6. When it imposed the Iranian assets freeze in 1980, the United States registered that freeze as a formal exchange control rule. Would this make the freeze more enforceable in Europe? For discussion of the legal issues raised by the Iranian freeze, see R. Edwards, *Extraterritorial Application of the U.S. Iranian Assets Control Regulations*, 45 AM. J. INT'L L. 870 (1981).

7. Suppose an exchange control rule purported to apply to outstanding letters of credit. What approaches might you take to resolving the strong conflict of policies? For interesting examples, see *Zeevi & Sons v. Grindlays Bank [Uganda]*, 37 N.Y.2d 220, 371 N.Y.S.2d 892 (1975), *cert. denied*, 423 U.S. 866 (1975); *United City Merchants (Investments) v. Royal Bank of Canada*, [1982] 2 A.E.R. 720. For discussion of the effects of the Iranian freeze on letters of credit of which the Iranian Government, its agencies or instrumentalities were the beneficiary, see Michael P. Malloy, *The Iran Crisis: Law Under Pressure*, 1984 WISC. INT'L L.J. 15 (1984).

8. Suppose that after signing a loan agreement and borrowing under it, Ruritania passed an exchange control law that prohibited payment of the loan, and a lending bank sought to collect on the loan out of Ruritanian assets in your court's jurisdiction. What

holding? *See Libra Bank v. Banco Nacional de Costa Rica,* 570 F. Supp. 870 (S.D.N.Y. 1983).

9. Do you think you could tell an "exchange contract" from a contract that simply happens to involve foreign exchange? (This is the most common judicial method for evading the IMF rule.) Is there a difference between two such contracts? The following excerpt offers some added perspective on the role of IMF Charter article VIII(2)(b) in the courts. As you read the excerpt, consider whether *Banco Frances* has had any significant impact on the case law on this issue.

Gerhard Wegen, 2(b) or Not 2(b): Fifty Years of Questions– The Practical Implications of Article VIII Section 2(b)

62 Fordham L. Rev. 1931 (1994)

. . . Interpretation of section 2(b) is greatly complicated by the fact that the clause is contained in a multilateral agreement under public international law that was drafted in a very short period of time, and then only in the English language, which is uncommon with multilateral documents. I believe that it was drafted within two or three days, and in a peculiar type of language which resembles neither that of the common law lawyer nor that of the continental lawyer. The first sentence of section 2(b) states:

> Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member.[2]

It is worthwhile to compare non-official German and French versions. The unofficial German text reads:

> *Aus Devisenkontrakten, welche die Wahrung eines Mitglieds der führen und den von diesem Mitglied in Übereinstimmung mit diesem Übereinkommen aufrechterhaltenen oder eingeführten Devisenkontrollbestimmungen zuwiderlaufen, kann in den Hoheitsgebieten der Mitglieder nicht geklagt werden*.[3]

A French translation, upon which the Belgian, French, and Swiss authorities agreed, reads:

> *Les contrats relatifs aux devises qui portent sur la monnaie d'un membre et qui sont en opposition avec la réglementation du contrôle des changes de ce membre maintenue ou imposée conformément au présent accord n'auront pas force obligatoire dans les territoires de tout membre*.[4]

It is obvious that while the English version talks about "exchange contracts which are unenforceable," the German version says "contracts which cannot be put before the court," and the French version says "contracts which have no binding force." Therefore, on the very basic level of language, the various versions are inconsistent. Adding to this

2. [Second Amendment of Articles of Agreement of the International Monetary Fund, Apr. 30, 1976, 29 U.S.T. 2203,] art. VIII § 2(b) [hereinafter Articles of Agreement].

3. This version appears in Bundesgesetzblatt, Teil II BGBl.II 1978, 13, 34-35.

4. This translation is quoted in 3 SIR JOSEPH GOLD, THE FUND AGREEMENT IN THE COURTS 629 (1986).

difficulty, no single international court interprets this clause, and thus no one single authoritative interpreter exists.

It is also important to realize that different countries may view this clause in different ways. On the one hand, a court might judge the clause under principles of public international law, which are typically used to interpret the instruments of public international law, and which are familiar to public international lawyers. On the other hand, a court may evaluate it under a conflict of laws approach . . . as a question of what law to apply to a transaction, or which substantive law holds contracts to be unenforceable.

The distinction between public law and private law, which is very pronounced in the German system, is also relevant to interpreting section 2(b) with regard to national exchange control regulations. The section might be considered to fall either under public law as an exchange control regulation imposed by the state, or under private law because it provides that private contracts may be found unenforceable. Elements of public policy further complicate the construction of section 2(b). These elements include protecting the forum state's status as a financial center and safeguarding the rights of both debtors and creditors. . . .

Even though the Bretton Woods Agreement is a treaty under public international law, one of its main purposes was to deal, for the first time, with exchange control regulations on a private basis. Prior to Bretton Woods, exchange control regulations were looked at from a perspective of public law only. The so-called "revenue rule" has traditionally provided that rules of public law are only applicable within the territory of the state in which they were created, and do not have extra-territorial application. The parties to the Bretton Woods Agreement, however, wanted to establish a regime in which exchange control regulations of one state could be enforced in other states. In other words, section 2(b) is intended to establish extraterritorial recognition of foreign exchange controls in the member states to the International Monetary Fund.

Of course, in order to make section 2(b) effective with regard to individuals, it was necessary to implement it in the national legal systems of each member state. This was accomplished by obligating the member states in the Agreement to do so in such a way that it would be enforced in their legal systems.[8] Implementation of a rule that is contained in a multilateral agreement under public international law can be accomplished in different ways. One alternative is simply to enact the text into national law. The second alternative is to state in national law that Article VIII, section 2(b) of the Bretton Woods Agreement will be given effect within the country. The third alternative is to ratify the Agreement and leave open the specific means for providing for its effectiveness in the country. The United States, which falls into the second category, deals with the problem through section 11 of the Bretton Woods Agreement Act of 1945:

> The provisions of article IX, sections 2 to 9, both inclusive, and the first sentence of article VIII, section 2(b), of the Articles of Agreement of the Fund . . . shall have full force and effect in the United States and its Territories and possessions upon acceptance of membership by the United States in, and the establishment of, the Fund and the Bank, respectively.[9]

8. *See* Articles of Agreement, . . . art. XX § 2a; Werner F. Ebke, *Article VIII, Section 2(b), International Monetary Cooperation, and the Courts*, 23 INT'L LAW. 677, 684 & n.39 (1989) [hereinafter International Monetary Cooperation].

9. 22 U.S.C. § 286h (1988).

By contrast, in states such as Australia, Mexico, and Sweden, it is still not clear from the ratification process whether Article VIII, section 2(b) was actually adopted into domestic law.[10] It could be argued, however, that such implementation is not actually necessary because the states falling into this category have ratified the instruments as such.

A consequence of adoption into domestic law is that, although enacted on an international level, no international court has jurisdiction to interpret section 2(b). Instead, it is the national courts of the member states which have construed it. The writings of scholars such as Sir Joseph Gold,[11] F.A. Mann,[12] Professor Arthur Nussbaum,[13] and, most recently, Professor Werner Ebke[14] have also impacted greatly on the clause's interpretation. . . .

. . . [I]n many instances over the last fifty years courts have simply disregarded the rules on a systematic level because neither the parties, counsel, nor the court thought of invoking section 2(b). Thus, it is difficult to assess the true applicability of the clause. In the early years, there was a great reluctance to deal with the clause at all. In the United States, the first wave of cases came about due to war-related immigration matters, in which U.S. institutions sued non-U.S. citizens, or vice-versa.[15] The second series of cases developed around the Cuban socialist revolution, in particular the so-called Cuban insurance cases.[16] Since the late 1970s, the clause has become very important in international finance transactions, particularly those involving U.S. citizens dealing with foreign banks and foreign countries.[17] European case law, including Germany's, developed mainly in international trade cases.[18] Thus, a certain case law did develop in all major jurisdictions. But no cases appear to have arisen in smaller countries, such as Switzerland, which of course is an important jurisdiction in international banking transactions. . . .

The first issue concerning section 2(b)'s interpretation is how to characterize it–that is, whether it should be considered a rule of conflict of laws or a rule of substantive law. In Germany, the question also arises whether it is a rule of civil procedure or of substantive law. In general, section 2(b) has characteristics of its own that impact public law, private law, and substantive law.

Germany characterizes section 2(b) in accordance with the law of each member state that applies it. Because section 2(b) has been implemented into the laws of the various member states on a domestic level, Germans leave its characterization to the respective legal system that applies in a particular case. Thus, German law views section 2(b) as

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10. For a discussion regarding the legal status of § 2(b) in these three countries, see WERNER F. EBKE, INTERNATIONALES DEVISENRECHT 162-63 (1991) [hereinafter Internationales Devisenrecht].

11. *See* Gold, *supra* note 4; SIR JOSEPH GOLD, EXCHANGE RATES IN INTERNATIONAL LAW AND ORGANIZATION (1988); Sir Joseph Gold, *Developments in the International Monetary System, the International Monetary Fund, and International Monetary Law since 1971*, 174 Recueil des Cours 107 (1982).

12. *See* FREDERICK A. MANN, THE LEGAL ASPECT OF MONEY (5th ed. 1992).

13. *See* ARTHUR NUSSBAUM, MONEY IN THE LAW, NATIONAL AND INTERNATIONAL (2d ed. 1950).

14. For a detailed study which has begun to impact German jurisprudence on the subject, see Internationales Devisenrecht, *supra* note 10.

15. *See, e.g.*, *Southwestern Shipping Corp. v. National City Bank*, 160 N.E.2d 836 (N.Y.) (resolving a contract dispute between Italian concerns and an American bank, which implicated foreign exchange regulations of the Bretton Woods Agreement), *cert. denied* 361 U.S. 895 (1959); *Perutz v. Bohemian Discount Bank in Liquidation*, 110 N.E.2d 6 (N.Y. 1953) (deciding a suit between a U.S. citizen and a Czech bank); *Cermak v. Bata Akciova Spolecnost*, 80 N.Y.S.2d 782, 783 (Sup. Ct. 1948) (deciding an action by U.S. assignees to recover a deposit from a Czech corporation), *aff'd*, 90 N.Y.S.2d 680 (App. Div. 1949).

16. *See Varas v. Crown Life Ins. Co.*, 203 A.2d 505 (Pa. Super. Ct. 1964), *cert. denied*, 382 U.S. 827 (1965).

17. *See Libra Bank Ltd. v. Banco Nacional de Costa Rica*, 570 F. Supp. 870 (S.D.N.Y. 1983).

18. *See* Internationales Devisenrecht, *supra* note 10, at 173.

a conflict of laws rule that preempts rules for special statutory choice of law and general conflict of laws.[19] On the other hand, it could also be characterized under German law as a substantive law rule with procedural implications. As a choice of law rule, section 2(b) preempts other choice of law rules. In Germany, "due regard for the foreign exchange regulations of other countries" means that when such regulations are in place and in conformity with the Agreement, German public policy will not be invoked to disregard them. German law will, therefore, construe duly-promulgated foreign exchange control regulations to hold contracts unenforceable when appropriate; no recourse may be had to other German conflict of laws rules.

While this question may seem fairly esoteric, it actually has important practical consequences. Construing section 2(b) as a conflict of laws rule requires the application of the exchange control regulations of third states in Germany. But then the question arises as to what the legal consequences are when the rule ceases to be in force. For instance, a contract may be concluded under a foreign exchange control regulation which is later revoked by the state. Thus, at the time the contract was concluded, it was contrary to the foreign exchange control regulations of another state, but is no longer so. If section 2(b) is considered a rule of substantive law, however, then two alternatives exist: either the contract will be considered invalid and unenforceable from the beginning, or the exchange control regulation constitutes a condition which was present but has now disappeared, so that the contract was unenforceable but has now become enforceable.

In the United States, courts have sometimes refused to enforce contracts that are contrary to the exchange control regulations of other countries not based on the language of section 2(b), but on the act of state doctrine.[20] This is uncommon for us on the Continent of Europe, because we do not recognize an act of state doctrine to the same extent as the United States. Another important question that sometimes arises is whether a member state's public policy considerations may override section 2(b). The basic problem in this regard is whether foreign exchange control regulations may be denied enforcement in the forum state based on that state's public policy.

Although no German case has been decided on this point, Germans would argue that once section 2(b) finds an application, the public policy of the forum state cannot override it. It could, however, be argued that public policy should come into play where basic notions of justice and fairness are concerned; one example would be when foreign exchange control regulations of another state are promulgated in conformity with the Agreement, but violate basic notions of justice recognized in Germany, such as discrimination on the basis of race or religion. . . .

Another problem that arises concerns arbitrability–that is, whether the parties can submit to arbitration the question of whether a contract is an exchange contract under Article VIII, section 2(b), and whether section 2(b) should be taken into account by arbitral tribunals. There has been some debate on this issue, and a case has even come up before the International Chamber of Commerce.[21] Though in that case the arbitral tribunal unfortunately misconstrued the nature of section 2(b) and stated that it should only apply to state contracts, it is generally accepted that arbitral tribunals should take

19. *See* International Monetary Cooperation, *supra* note 8, at 684.

20. *See, e.g., Allied Bank Int'l v. Banco Credito Agricola de Cartago*, 566 F. Supp. 1440 (S.D.N.Y. 1983) (holding the act of state doctrine as meritorious in defending against a suit for a loan default), *rev'd*, 757 F.2d 516 (2d Cir.), *cert. denied*, 473 U.S. 934 (1985). . . .

21. This case is described in Internationales Devisenrecht, *supra* note 10, at 164.

note of section 2(b) if the facts indicate that section 2(b) may be involved. Thus, the arbitral tribunal should raise the issue on its own motion if it is appropriate, even if the parties do not raise it.

Finally, questions arise under section 2(b) with regard to the recognition and enforcement of judgments. For example, in an English case, the court took the position that only currency contracts, *i.e.*, contracts to exchange one currency against another, could be considered exchange contracts.[23] That case concerned a futures contract. The English plaintiff, a brokerage firm, prevailed against an Italian defendant. As the Italian defendant had no assets in England, the English plaintiff attempted to enforce the judgment in Italy, but the Italian court refused, based on public policy grounds and a narrow interpretation of section 2(b). . . .

[The concept of an "exchange control"] has given rise to much debate and diversity of opinion between the legal systems of the United States/United Kingdom and those of continental Europe. The United States and the United Kingdom, following Professor Nussbaum's lead, define exchange contracts as contracts that have as their subject the exchange of currency, meaning currency contracts in the narrowest sense.[24] On the other hand, the continental systems, and particularly Germany, define exchange contracts as contracts that have as their essential nature an exchange of goods or services that has an impact on the foreign exchange reserves available in that country.[25] Thus, on the Continent, any contract for the sale of goods or for services involving a currency and which would lead to a decrease or increase in the foreign exchange funds of the member states is considered an exchange contract. In this broad notion of exchange contracts, virtually all contracts between parties residing in member states potentially have such an impact, and thus could be considered exchange contracts. This broader interpretation, which was developed in particular by F.A. Mann,[26] seems to further the goals of the Agreement more effectively, since it subjects more contracts to section 2(b). Thus more transactions will have to be concerned with the foreign exchange regulations of member states and their impact in the forum state.

In Germany, the U.S./U.K. view has traditionally been incomprehensible. Germany regards contracts such as those for the sale of goods, for services, life insurance contracts, surety contracts, guarantees, and so-called "acknowledgments of debt" (*Schuldanerkenntnisse*) all as potential exchange contracts. This is also true for contracts regarding international monetary commitment agreements and international money collection agreements. One current problem concerns international loan agreements. Common law courts, for instance a federal court in the Southern District of New York, have explicitly stated that international loan agreements are not to be considered exchange contracts, based on their desire to maintain the position of the forum as an international financial center.[27] By contrast, Germany generally considers international loan agreements to be exchange contracts under section 2(b), which may account for the reluctance to select the application of German law in international loan agreements.

But a recent case indicates that the German courts are becoming slightly more flexible with regard to the types of contracts that are considered "exchange contracts" under

23. *See Wilson, Smithett & Cope Ltd. v. Terruzzi*, 1976 1 Q.B. 703, 713 (C.A.).

24. *See* International Monetary Cooperation, *supra* note 8, at 687.

25. *See id.* at 687-89.

26. *See* Mann, *supra* note 12, at 378-86.

27. *See, e.g., Libra Bank Ltd. v. Banco Nacional de Costa Rica,* 570 F. Supp. 870, 900 (S.D.N.Y. 1983) (holding that a contract to borrow U.S. currency, which requires U.S. currency, and which designates New York as the situs of repayment, was not an exchange contract within the meaning of § 2(b)); *see also* International Monetary Cooperation, *supra* note 8, at 687.

section 2(b). In a case involving a Bulgarian limited partner that had attempted to rely on the provision as grounds for refusing to pay an increased capital contribution to a German limited partnership, the German Federal Supreme Court (*Bundesgerichtshof*) ruled for the first time that international capital transfers do not fall under section 2(b).[29] . . .

Determining whether particular exchange control regulations are maintained or imposed consistently with the Agreement is obviously a difficult assessment for a court to make. Since most courts, not to mention most attorneys, are hardly experts in the technicalities of foreign exchange regulations, under the Bretton Woods Agreement it is possible to request the executive board of the International Monetary Fund to make this assessment.[30] . . .

The . . . legal consequence that such contract is unenforceable[,] [t]ogether with the question of what is an exchange contract, . . . is one of the areas in which common law countries diverge most sharply from the continental legal systems. The concept of unenforceability is a common law concept deriving from the system of actions under Roman law, and it is fairly obvious to a common law lawyer that there are obligations or contracts which may be unenforceable in court. This concept is difficult for a continental lawyer, who instead speaks of the "voidness" of a contract.

Shortly after World War II, F.A. Mann, among others, proposed that an exchange contract that violates foreign exchange regulations should be considered void. But this result is highly questionable because foreign exchange regulations may be imposed at one time and terminated later, just as states may join the Agreement and then leave it later. Thus, the problem with Mann's view is that the contract would be void *ab initio*, and therefore could not be void later.

The German courts have gone in a completely different direction by deciding that contracts which were contrary to foreign exchange control regulations could be valid, but could not be enforced in court.[31] This view postulates the existence of a new procedural requirement for a contract to be sued upon in court–that is, that it does not violate exchange control regulations. Thus, a German court, in entertaining a suit, may decide, either upon motion by the parties or upon its own motion, that section 2(b) is implicated and that the contract violates it. In such a case, the court would dismiss the suit and find the contract inadmissible on procedural grounds; it would not reach a decision on the merits. Germany's trend seems to be that such contracts should be regarded, as they are in the common law world, as imperfect, even though they continue to be binding obligations. The result is that there may be a kind of conditional validity of the contract, *i.e.*, that the contract may exist, but that its existence is conditional on not being contrary to foreign exchange control regulations.[32] This concept is otherwise unknown to both continental and common law lawyers.

One important question that arises in practice concerns the status of accessory security taken under an exchange contract which is then not enforceable. This question also arises with regard to sureties and guaranties, and with set-offs, when the claim which may be set off is unenforceable under section 2(b). Or, what are the consequences

29. *See* Judgment of Nov. 8, 1993, BGH, W. Ger., 1994 Recht der internationalen Wirtschaft RIW 151; Judgment of Feb. 22, 1994, BGH, W. Ger., 1994 RIW 327.

30. *See* Articles of Agreement, . . . at art. XXIX. For a discussion of this procedure, see International Monetary Cooperation, *supra* note 8, at 697-98.

31. *See* Judgment of Apr. 27, 1970, BGH, W. Ger., 1970 Wertpapiermitteilungen WM 785, 786; Order of Dec. 21, 1976, BGH, W. Ger., 1976 Die deutsche Rechtssprechung auf dem Gebiete des internationalen Privatrechts IPRspr 342, 343.

32. *See* Judgment of Apr. 27, 1970, BGH, W. Ger., 1970 WM 785, 786.

when one of the parties claims damages under a contract which is declared unenforceable under section 2(b)? All of these incidental problems are basically decided along the same split we have seen earlier: the U.S./U.K. courts and scholars would tend to narrowly construe section 2(b), saying that the section applies to exchange contracts only, and not to other instruments of international trade such as letters of credit, sureties, and the like. German courts, however, would state that "full faith and credit" should be given to section 2(b), and that if a contract is declared unenforceable, then any legal transaction immediately prior to that contract must also be unenforceable. This would also apply to a surety or guaranty which is tainted by the contract's unenforceability. . . .

A few matters concerning section 2(b) that are important under German law remain. The first is the concept of enforceability as a procedural requirement that the court must examine on its own motion. Up until the time at which a judgment is rendered, the court may examine the concept of the enforceability of a contract based on foreign exchange controls. There are three instances of such examination in Germany: the lower court, the appellate level, and the federal level.

Typically, section 2(b) defenses come into play at the appellate or the federal levels only, because at these levels both counsel and the courts tend to be more sophisticated. In many instances, defenses based on section 2(b) are often brought in as a last resort, sometimes after many years of litigation. It often happens that the first two levels fully litigated the matter and made findings of fact, and then one of the parties raises the issue of section 2(b) at the last moment at the federal level. In such a case, the party making the submission may invoke the lack of a procedural requirement (namely, that of an enforceable contract), causing the whole case to fall apart. This is a real problem in Germany, and one which does justice to neither the plaintiff nor the defendant.

Secondly, Germany procedurally requires the plaintiff to substantiate and put forward all of his arguments. So section 2(b) is not viewed as a defense that must be invoked by the defendant, but as a procedural requirement requiring the plaintiff to prove its non-application.[33] The common law system, by contrast, views section 2(b) as a defense that must be raised by the defendant.[34] Under the German view, therefore, if the plaintiff fails to substantiate its claim that the court should not apply section 2(b), the complaint would be dismissed without the court having reached a decision on the merits. This can have practical implications with regard to the issuance of international bonds. Germany is a major provider of capital in the international markets, which involves issuing Deutsche Mark bonds under German law. If litigation is then brought before the German courts and the plaintiff fails to meet its burden, the bondholders are at risk of not having their money repaid. Luckily there are signs that the situation may change in Germany, particularly due to the scholarly work of Professor Ebke–that is, that section 2(b) may be looked upon as a defense which is based on the concept of an imperfect obligation. . . .

Section 2(b) will likely play an ever-increasing role in international loans and international bonds. There are certainly problems in this regard on the European Continent caused by the broad interpretation of section 2(b). The fall of eastern Europe's

33. *See* Judgment of Apr. 27, 1970, BGH, W. Ger., 1970 WM 785, 786-87; *see also* International Monetary Cooperation, *supra* note 8, at 700-01.

34. *See, e.g.*, *Libra Bank Ltd. v. Banco Nacional de Costa Rica*, 570 F. Supp. 870, 902 (S.D.N.Y. 1983) (finding that the defendant failed to sustain its burden of proof that its currency restrictions were exempt from IMF approval requirements); *see also* International Monetary Cooperation, *supra* note 8, at 701.

socialist countries and the rise of a host of new states which are becoming members of the Agreement, together with a scarcity of capital and the problems of many of these states, will also likely lead to a host of new foreign exchange regulations, which can only increase the importance of section 2(b) in the future.

NOTES AND QUESTIONS

1. Should IMF Charter art. VIII, § 2(b) be characterized as a of conflict-of-laws rule, a rule of substantive law, or a civil procedure rule? What practical difference would the characterization make in litigation?

2. How might a German court have decided a case like *Vishipco*? *Weston Banking*? *Allied Bank*, *infra* at [redacted]?

3. Wegen suggests that U.S. courts tend to resolve exchange control disputes in terms of the act of state doctrine, rather than by application of article VIII § 2(b). Does this affect the outcome in such cases?

4. On the issue of what constitutes an "exchange contract" for purposes of article VIII § 2(b), which approach is preferable–the U.S.-U.K narrow construction, or the broader continental reading of the term? Which makes more sense with respect to litigation over international lending agreements?

5. If article VIII § 2(b) is applied to an international contract, should the result be that the contract is void *ab initio*, or should it merely be considered voidable–*i.e.*, to be rendered void only if, at the time the controversy is presented to a court, the exchange controls are still operative?

C. PREVENTION AND MANAGEMENT OF DEFAULT

The international system just described assists nations in managing their monetary systems and in foreign enforcement of their exchange control regulations. The international banking crises that began with the default of Mexico in 1982, however, have produced a further generation of regulations. Some of these are designed to assist banks in avoiding problem loans; some, just beginning to be developed, are designed to provide fairness among different creditors, and perhaps to assist debtor nations to avoid default.

1. Domestic Regulation of International Capital Flows

Details of banking regulation differ radically from nation to nation. Most have specific requirements affecting, for example, the ratio of loans to capital, together with various forms of auditing, disclosure, and self-regulation procedures. These are enforced by a variety of agencies. including, in the United States, the Office of the Comptroller of the Currency (a bureau of the Treasury Department that charters and supervises national banks), the Board of Governors of the Federal Reserve System (the nation's central bank), and the Federal Deposit Insurance Corporation (FDIC) (the federal insurer of bank deposits and receiver for failed U.S. banks). Most of these regulations are designed primarily to affect domestic transactions and the safety and soundness of the U.S. banking system. Only a few apply explicitly to international transactions.

U.S. regulations largely rely on market mechanisms to control banking activities, in the sense that many are reporting requirements designed to increase information available to the federal regulators–and indirectly to bank investors and depositors. Before enactment of a five-point plan in 1983, the international lending activities of U.S. banks were largely controlled by the following rules, which still apply:

> (1) U.S. banks are subject to a statutory lending limit in 12 U.S.C. §84, which limits lending to any one person at any one time to 15 percent of the bank's unimpaired capital and surplus (plus an additional and separate lending limit of 10 percent applicable to loans fully secured by "readily marketable security" (*e.g.*, listed securities, gold bullion). The implementing regulations explain what is a separate person for these purposes:
>
> > § 32.5 Combination rules.
> >
> > (a) General rule. Loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed a borrower–
> >
> > (1) When proceeds of a loan or extension of credit are to be used for the direct benefit of the other person, to the extent of the proceeds so used; or
> >
> > (2) When a common enterprise is deemed to exist between the persons.
> >
> > (b) Direct benefit. The proceeds of a loan or extension of credit to a borrower will be deemed to be used for the direct benefit of another person and will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services.
> >
> > (c) Common enterprise. A common enterprise will be deemed to exist and loans to separate borrowers will be aggregated:
> >
> > (1) When the expected source of repayment for each loan or extension of credit is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid. An employer will not be treated as a source of repayment under this paragraph because of wages and salaries paid to an employee, unless the standards of paragraph (c)(2) of this section are met;
> >
> > (2) When loans or extensions of credit are made–
> >
> > (i) To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and
> >
> > (ii) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues/expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments;
> >
> > (3) When separate persons borrow from a bank to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests, in which case a common enterprise is deemed to exist between the borrowers for purposes of combining the acquisition loans; or
> >
> > (4) When the OCC determines, based upon an evaluation of the facts and circumstances of particular transactions, that a common enterprise exists.
> >
> > (d) Special rule for loans to a corporate group.
> >
> > (1) Loans or extensions of credit by a bank to a corporate group may not exceed 50 percent of the bank's capital and surplus. This limitation applies only to loans subject to the combined general limit. A corporate group includes a person and all of its subsidiaries. For purposes of this paragraph, a corporation or a limited liability company is a subsidiary of a person if the person owns or beneficially owns directly or indirectly more than 50 percent of the voting securities or voting interests of the corporation or company.
> >
> > (2) Except as provided in paragraph (d)(1) of this section, loans or extensions of credit to a person and its subsidiary, or to different subsidiaries of a person, are not combined unless either the direct benefit or the common enterprise test is met.

(e) Special rules for loans to partnerships, joint ventures, and associations–

(1) Partnership loans. Loans or extensions of credit to a partnership, joint venture, or association are deemed to be loans or extensions of credit to each member of the partnership, joint venture, or association. This rule does not apply to limited partners in limited partnerships or to members of joint ventures or associations if the partners or members, by the terms of the partnership or membership agreement, are not held generally liable for the debts or actions of the partnership, joint venture, or association, and those provisions are valid under applicable law.

(2) Loans to partners.

(i) Loans or extensions of credit to members of a partnership, joint venture, or association are not attributed to the partnership, joint venture, or association unless either the direct benefit or the common enterprise tests are met. Both the direct benefit and common enterprise tests are met between a member of a partnership, joint venture or association and such partnership, joint venture or association, when loans or extensions of credit are made to the member to purchase an interest in the partnership, joint venture or association.

(ii) Loans or extensions of credit to members of a partnership, joint venture, or association are not attributed to other members of the partnership, joint venture, or association unless either the direct benefit or common enterprise test is met.

(f) Loans to foreign governments, their agencies, and instrumentalities–

(1) Aggregation. Loans and extensions of credit to foreign governments, their agencies, and instrumentalities will be aggregated with one another only if the loans or extensions of credit fail to meet either the means test or the purpose test at the time the loan or extension of credit is made.

(i) The means test is satisfied if the borrower has resources or revenue of its own sufficient to service its debt obligations. If the government's support (excluding guarantees by a central government of the borrower's debt) exceeds the borrower's annual revenues from other sources, it will be presumed that the means test has not been satisfied.

(ii) The purpose test is satisfied if the purpose of the loan or extension of credit is consistent with the purposes of the borrower's general business.

(2) Documentation. In order to show that the means and purpose tests have been satisfied, a bank must, at a minimum, retain in its files the following items:

(i) A statement (accompanied by supporting documentation) describing the legal status and the degree of financial and operational autonomy of the borrowing entity;

(ii) Financial statements for the borrowing entity for a minimum of three years prior to the date the loan or extension of credit was made or for each year that the borrowing entity has been in existence, if less than three;

(iii) Financial statements for each year the loan or extension of credit is outstanding;

(iv) The bank's assessment of the borrower's means of servicing the loan or extension of credit, including specific reasons in support of that assessment. The assessment shall include an analysis of the borrower's financial history, its present and projected economic and financial performance, and the significance of any financial support provided to the borrower by third parties, including the borrower's central government; and

(v) A loan agreement or other written statement from the borrower which clearly describes the purpose of the loan or extension of credit. The written representation will ordinarily constitute sufficient evidence that the purpose test has been satisfied. However, when, at the time the funds are disbursed, the bank knows or has reason to know of other information suggesting that the borrower will use the proceeds in a manner inconsistent with the written representation, it may not, without further inquiry, accept the representation.

(3) Restructured loans–

(i) Non-combination rule. Notwithstanding paragraphs (a) through (e) of this section, when previously outstanding loans and other extensions of credit to a foreign government, its agencies, and instrumentalities (i.e., public-sector obligors) that qualified for a separate lending limit under paragraph (f)(1) of this section are consolidated under a central obligor in a qualifying restructuring, such loans will not be aggregated and attributed to the central obligor. This includes any substitution in named obligors, solely because of the restructuring. Such loans (other than loans originally attributed to the central obligor in their own right) will not be considered obligations of the central obligor and will continue to be attributed to the original public-sector obligor for purposes of the lending limit.

(ii) Qualifying restructuring. Loans and other extensions of credit to a foreign government, its agencies, and instrumentalities will qualify for the non-combination process under paragraph (f)(3)(i) of this section only if they are restructured in a sovereign debt restructuring approved by the OCC, upon request by a bank for application of the non-combination rule. The factors that the OCC will use in making this determination include, but are not limited to, the following:

(A) Whether the restructuring involves a substantial portion of the total commercial bank loans outstanding to the foreign government, its agencies, and instrumentalities;

(B) Whether the restructuring involves a substantial number of the foreign country's external commercial bank creditors;

(C) Whether the restructuring and consolidation under a central obligor is being done primarily to facilitate external debt management; and

(D) Whether the restructuring includes features of debt or debt-service reduction.

(iii) 50 percent aggregate limit. With respect to any case in which the non-combination process under paragraph (f)(3)(i) of this section applies, a national bank's loans and other extensions of credit to a foreign government, its agencies and instrumentalities, (including restructured debt) shall not exceed, in the aggregate, 50 percent of the bank's capital and surplus.

12 C.F.R. § 32.5. Note particularly the effect of paragraph (f) of the rule, dealing with loans and extensions of credit to foreign governments, their agencies, and instrumentalities.

(2) The Comptroller of the Currency, Federal Reserve, and the FDIC administer minimum capital and capital adequacy requirements for the national and state-chartered banks that they supervise.[1] The current regulations implement the capital adequacy guidelines issued by the Bank for International Settlements (BIS), located in Basel, Switzerland.[2] (A revised BIS Capital Accord was approved in 2004 that will further refine capital adequacy rules for internationally active banks.[3])

(3) There is also an accounting principle that requires banks to write off interest due from a borrower once it is 90 days overdue. Normally, a hank will treat such an interest payment as paid on its books, whether or not it has been received, until the 90-day limit has been reached. The importance of this principle was demonstrated in the Spring of 1984, when a rescheduling of Argentine debt was negotiated just in time to save banks from having to write off significant losses against their first-quarter earnings. The regulation also implies that when U.S. banks enter into negotiations over debt rescheduling with a sovereign borrower, they will have a strong motive for maintenance of interest payments in order to prevent losses from appearing on their domestic income statements.

(4) The Securities and Exchange Commission (SEC) has imposed disclosure standards on bank holding companies with foreign loans. These include item 9 of Regulation S-X and Staff Accounting Bulletins 49 and 49A. Through these standards, publicly traded bank holding companies (which report to the SEC, in addition to being supervised by the Federal Reserve) are required to disclose information regarding large outstanding foreign loans.

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1. 12 C.F.R. pts. 3 (establishing capital adequacy requirements for national banks), 208 (state-chartered banks that are members of the Federal Reserve System), 225 app. A (bank holding companies), 325 (state-chartered, FDIC-insured banks).

2. BANK FOR INTERNATIONAL SETTLEMENTS, FINAL REPORT FOR INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS, *reprinted in* 4 Fed. Banking L. Rep. (CCH) ¶ 47-105 (Mar. 15, 1996). For discussion and analysis of the BIS guidelines, see Michael P. Malloy, *U.S. International Banking and the New Capital Adequacy Requirements: New, Old and Unexpected*, 7 ANN. REV. BANKING L. 75 (1988).

3. *See* Michael P. Malloy, *Capital Adequacy and Regulatory Objectives*, 25 SUFFOLK TRANSNAT'L L. REV. 299 (2002) (discussing likely impact of revised BIS Capital Accord).

> (5) An Interagency Country Exposure Review Committee, established by the three federal bank regulators in 1979, evaluates the risk associated with foreign loans and ranks foreign borrowers into six categories from strong to weak. This evaluation is then incorporated into the regulator's bank supervision.

The Regulations discussed in (l)-(5) were supplemented in late 1983 by the five-point program of the following legislation.

INTERNATIONAL LENDING SUPERVISION ACT OF 1983

Pub. L. No. 98-181, 97 Stat. 1153 (1983)

§ 902. Declaration of Policy

(a)(1) It is the policy of the Congress to assure that the economic health and stability of the United States and the other nations of the world shall not be adversely affected or threatened in the future by imprudent lending practices or inadequate supervision.

(2) This shall be achieved by strengthening the bank regulatory framework to encourage prudent private decisionmaking and by enhancing international coordination among bank regulatory authorities.

(b) The Federal banking agencies shall consult with the banking supervisory authorities of other countries to reach understandings aimed at achieving the adoption of effective and consistent supervisory policies and practices with respect to international lending. . . .

§ 904. Strengthened Supervision of International Lending

(a) Each appropriate Federal banking agency shall evaluate banking institution foreign country exposure and transfer risk for use in banking institution examination and supervision.

(b) Each such agency shall establish examination and supervisory procedures to assure that factors such as foreign country exposure and transfer risk are taken into account in evaluating the adequacy of the capital of banking institutions.

§ 905. Reserves

(a)(l) Each appropriate Federal banking agency shall require a banking institution to establish and maintain a special reserve whenever, in the judgment of such appropriate Federal banking agency–

(A) the quality of such banking institution's assets has been impaired by a protracted inability of public or private borrowers in a foreign country to make payments on their external indebtedness as indicated by such factors, among others, as–

(i) a failure by such public or private borrowers to make full interest payments on external indebtedness;

(ii) a failure to comply with the terms of any restructured indebtedness; or

(iii) a failure by the foreign country to comply with any International Monetary Fund or other suitable adjustment program; or

(B) no definite prospects exist for the orderly restoration of debt service.

(2) Such reserves shall be charged against current income and shall not be considered as part of capital and surplus or allowances for possible loan losses for regulatory, supervisory, or disclosure purposes.

(b) The appropriate Federal banking agencies shall analyze the results of foreign loan rescheduling negotiations, assess the loan loss risk reflected in rescheduling agreements, and, using the powers set forth in section 908 (regarding capital adequacy), ensure that the capital and reserve positions of United States banks are adequate to accommodate potential losses on their foreign loans.

(c) The appropriate Federal banking agencies shall promulgate regulations or orders necessary to implement this section within one hundred and twenty days after the date of the enactment of this title.

§ 906. Accounting for Fees on International Loans

(a)(1) In order to avoid excessive debt service burdens on debtor countries, no banking institution shall charge, in connection with the restructuring of an international loan, any fee exceeding the administrative cost or the restructuring unless it amortizes such fee over the effective life of each such loan.

(2)(A) Each appropriate Federal banking agency shall promulgate such regulations as are necessary to further carry out the provisions of this subsection.

(B) The requirement of paragraph (1) shall take effect on the date of the enactment of this section.

(b)(1) Subject to subsection (a), the appropriate Federal banking agencies shall promulgate regulations for accounting for agency, commitment, management and other fees charged by a banking institution in connection with an international loan.

(2) Such regulations shall establish the accounting treatment of such fees for regulatory, supervisory, and disclosure purposes to assure that the appropriate portion of such fees is accrued in income over the effective life of each such loan.

(3) The appropriate Federal banking agencies shall promulgate regulations or orders necessary to implement this subsection within one hundred and twenty days after the date of the enactment of this title.

§ 907. Collection and Disclosure of Certain International Lending Data

(a) Each appropriate Federal banking agency shall require, by regulation, each banking institution with foreign country exposure to submit, no fewer than four times each calendar year, information regarding such exposure in a format prescribed by such regulations.

(b) Each appropriate Federal banking agency shall require, by regulation, banking institutions to disclose to the public information regarding material foreign country exposure in relation to assets and to capital.

(c) The appropriate Federal banking agencies shall promulgate regulations or orders necessary to implement this section within one hundred and twenty days after the date of the enactment of this title.

§ 908. Capital Adequacy

(a)(1) Each appropriate Federal banking agency shall cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital for such banking institutions and by using such other methods as the appropriate Federal banking agency deems appropriate.

(2) Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its discretion, deems to he necessary or appropriate in light of the particular circumstances of the banking institution.

(b)(1) Failure of a banking institution to maintain capital at or above its minimum level as established pursuant to subsection (a) may be deemed by the appropriate Federal banking agency, in its discretion, to constitute an unsafe and unsound practice within the meaning of section 8 of the Federal Deposit Insurance Act [12 U.S.C. § 1818].

(2)(A) In addition to, or in lieu of, any other action authorized by law, including paragraph (1), the appropriate Federal banking agency may issue a directive to a banking institution that fails to maintain capital at or above its required level as established pursuant to subsection (a).

(B)(i) Such directive may require the banking institution to submit and adhere to a plan acceptable to the appropriate Federal banking agency describing the means and timing by which the banking institution shall achieve its required capital level.

(ii) Any such directive issued pursuant to this paragraph, including plans submitted pursuant thereto, shall be enforceable under the provisions of section 8(i) of the Federal Deposit Insurance Act [12 U.S.C. § 1818(i)] to the same extent as an effective and outstanding order issued pursuant to section 8(b) of the Federal Deposit Insurance Act which has become final.

(3)(A) Each appropriate Federal banking agency may consider such banking institution's progress in adhering to any plan required under this subsection whenever such banking institution, or an affiliate thereof or the holding company which controls such banking institution, seeks the requisite approval of such appropriate Federal banking agency for any proposal which would divert earnings, diminish capital, or otherwise impede such banking institution's progress in achieving its minimum capital level.

(B) Such appropriate Federal banking agency may deny such approval where it determines that such proposal would adversely affect the ability of the banking institution to comply with such plan.

(C) The Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury shall encourage governments, central banks, and regulatory authorities of other major banking countries to work toward maintaining and, where appropriate, strengthening the capital bases of banking institutions involved in international lending.

§ 909. Foreign Loan Evaluations

(a)(1) In any case in which one or more banking institutions extend credit, whether by loan, lease, guarantee, or otherwise, which individually or in the aggregate exceeds $20,000,000, to finance any project which has as a major objective the construction or operation of any mining operation, any metal or mineral primary processing operation, any fabricating facility or operation, or any metal-making operations (semi and finished) located outside the United States or its territories and possessions, a written economic feasibility evaluation of such foreign project shall be prepared and approved in writing by a senior official of the banking institution, or, if more than one banking institution is involved, the lead banking institution, prior to the extension of such credit.

(2) Such evaluation shall–

(A) take into account the profit potential of the project, the impact of the project on world markets, the inherent competitive advantages and disadvantages of the project over the entire life of the project, and the likely effect of the project upon the overall long-term economic development of the country in which the project is located; and

(B) consider whether the extension of credit can reasonably be expected to be repaid from revenues generated by such foreign project without regard to any subsidy, as defined in international agreements, provided by the government involved or any instrumentality of any country.

(b) Such economic feasibility evaluations shall be reviewed by representatives of the appropriate Federal banking agencies whenever an examination by such appropriate Federal banking agency is conducted.

(2) No private right of action or claim for relief may be predicated upon this section.

NOTES AND QUESTIONS

1. Whom does the 15 percent lending limit protect?

2. Would the limit allow a bank to lend 9 percent of its capital to the Republic of Mexico and another 9 percent to Pemex, the Mexican state-owned oil company? What additional data might you want before writing an opinion letter on this question?

3. What about the rules on accounting for fees? Why do you think they are there?

4. Do you think these regulations are likely to help prevent the next wave of overlending, whatever that wave may be (developing nations, oil tankers, etc.)?

5. For examples of the new regulations issued in accordance with the statute, see the group issued by the Comptroller, the Federal Reserve, and the FDIC at 49 Fed. Reg. 5587 (February 13, 1984). The current versions of the rules appear at 12 C.F.R. pts. 20, 211, 351. For additional background, *see* Cynthia C. Lichtenstein, *U.S. Banks and the Eurocurrency Markets: The Regulatory Structure*, 99 BANKING L.J. 484 (1982); Ronald David Greenberg, *The Eurodollar Market: The Case for Disclosure*, 71 CAL. L. REV. 1492 (1983).

2. Management of Default

In spite of all the efforts just described, a number of nations have been unable to meet the payments on their loans, and have negotiated reschedulings. These are typically handled in two separate negotiations, one at the “Paris Club” in which the public creditors, including the IMF and the World Bank, agree on terms of extension, and a second, less formal one in which private banks agree to a rollover, or perhaps to the advancement of new loans to meet current Interest payments. The process and its implications are described in the following excerpt.

Walker F. Todd, A Brief History of International Lending, From a Regional Banker's Perspective

11 Geo. Mason U. L. Rev. 1 (1989)

In December 1987, the United States financial services industry passed the fourth of four significant milestones within one year in the evolution of the developing country debt problem or 'LDC' [*i.e.*, “less develop country”] debt crisis. In February, Brazil announced a unilateral suspension of debt service to banks. Then, in May, Citicorp announced the creation of special loan loss reserves equal to about twenty-five percent of its Brazilian and selected other LDC credit exposure. Subsequently, forty-three of the fifty largest United States bank holding companies created similar reserves, principally to cover LDC exposures. Third, in mid-December, several large regional banks in the United States announced the first actual charge-offs of portions of their LDC credit exposures and the creation of enough additional loan loss reserves to bring remaining LDC credit exposures into line with current secondary market prices for LDC debt, generally in the neighborhood of fifty to sixty percent reserved or charged off.[14]

Finally, at year-end 1987, press reports indicated that the Government of Mexico, the United States Treasury, and J. P. Morgan had agreed on a proposal to exchange up to $10 billion of new, 20-year, interest-bearing Mexican bonds for up to $20 billion of outstanding Mexican loans owed to the banks participating in the arrangement. After the press statements, several large United States regional banks and foreign banks indicated their willingness to make tenders for bonds under the plan. Mexico proposed to use up to $2 billion of its $11 to $13 billion of foreign currency reserves to purchase a new issue of 20-year, zero-coupon United States treasury bonds with a value at maturity equal to the principal value of the Mexican bonds and to place the United States bonds in escrow inside the United States to secure the Mexican bonds, thereby insuring investors of repayment of principal at maturity. Some interest rate risk would remain for investors because the Mexican bonds would bear floating interest rates at a margin above LIBOR (London interbank offered rate) that is about twice the current interest margin for rescheduled Mexican debt. . . . In fact, press reports following the Mexican debt exchange indicated that only 139 of the estimated 560 banks eligible to submit bids actually did so. Only ninety-five bids were accepted, with an estimated value of $2.56 billion, in exchange for $3.67 billion of Mexican debt. . . .

The official beginning of the LDC debt crisis was the public announcement of the Mexican payment difficulties in 1982. On August 15, 1982, the Mexican Finance Minister, Jesus Silva Herzog, met a group of more than 100 United States and foreign bankers in New York City and announced the end of Mexico's capacity to service its external, hard-currency debt obligations. Mexico's currency reserves were completely exhausted, and there was a scarcity of available, unpledged foreign assets that Mexico could use to secure new borrowings, but such assets somehow were found anyway. For a time, after the Mexican interruption of debt service, some large LDC debtors still were able to maintain debt service on a country-by-country basis. Brazil still could roll over maturing short-term bank credits until early December 1982, but then Brazil also temporarily interrupted its debt service, due to what was then characterized as short-term liquidity crisis. Then one by one, Argentina, Venezuela, and eventually every continental country in Latin America except Colombia and Paraguay, interrupted their foreign debt service. Each of those countries arranged restructurings of its external debt, usually under the auspices of the International Monetary Fund (IMF). . . .

The 1982-1985 era is remembered in commercial and central banking circles as the era of the initial reschedulings and new money loans. The principal justification for temporizing, advanced in official circles at the outset of the crisis, was to buy time, which made apparent good sense if all that was involved was a short-term liquidity crisis. However, when Poland suspended its external debt service in April 1981, a signal was sent that should have been hard to ignore regarding the future course of the LDC debt crisis. Procedures followed during the Polish debt crisis, which lasted five years before there was movement in the direction of an IMF program for Poland, proved to be leading indicators of actions taken with other LDCs and should have indicated whether the normal, so-called 'orthodox' approach to adjustment by LDCs was going to succeed

14. . . . With the exception of two large regional bank holding companies that have only 20 and 25 percent reserves for LDC debt exposure, and three large regional bank holding companies that have only negligible LDC debt exposure and no LDC debt reserves, the range of reserves among 23 large regional bank holding companies is from 43 to 100 percent of exposure, with a central tendency around 55 percent reserves. In contrast, among ten large New York City and Chicago bank holding companies, the range of LDC debt reserves is from 22 to 40 percent, with a central tendency around 25 percent.

over the long haul.

The use of the new money loan, attributed in the literature to Jacques de Larosière, then head of the IMF, staved off legal default by roughly but just barely keeping interest payments current for a host of third world debtors in the 1982-1985 era. Unfortunately, new money lending also unwittingly and inexorably increased the outstanding principal owed by the debtors. The foreign debts of Mexico and Brazil increased from about $80 billion in 1982 to about $105 billion for Mexico and $114 billion for Brazil at year-end 1987, with very little in the way of useable funds provided in the interim. In the $4 billion and $5 billion new money credits arranged for Mexico and Brazil in 1983-85, as many as 530 banks were requested to act in unison–a difficult task in the best of times, and a nearly impossible one in those circumstances. Somehow this task was completed, but with progressively less participation by United States regional and some foreign banks, which contributed to the increased concentration of LDC loan problems in United States money center banks after 1982.

. . . The nine largest money center banks (excluding Continental Illinois) had total capital then of $27.1 billion, but their exposure to developing countries was $54.3 billion, more than twice their capital. Total United States bank claims on the fifteen countries later declared eligible for the Baker Plan were $90.2 billion in 1982. Thus, sixty percent of all United States banks' exposure to the most troubled developing countries was held by the nine largest banks. While most LDC debt exposure of European banks was in Africa, Asia, and Eastern Europe, the bulk of United States banks' exposure was in Latin America. Four debtor nations alone, Mexico ($23.6 billion), Brazil ($23.0 billion), Argentina ($9.1 billion), and Venezuela ($8.4 billion), accounted for three-fourths of all United States banks' exposure to the fifteen heavily indebted countries by June 1987. . . .

After the initial round of reschedulings in 1982-1984, a generally improved world economic outlook made bankers and central bankers optimistic that the new money lending approach might work after all. By early 1985, Mexico and Brazil had accumulated modest or, in Brazil's case, significant surpluses in their current account balances due to the application of the classic IMF formulas for adjustment–suitably modified, of course, because domestic inflation never really was controlled in either country. But exports were stimulated, imports were reduced drastically, and enough new money loans were provided to cover debt service needs. However, the original, orthodox plan seemed to be faltering as the year 1985 progressed. The Baker Plan, announced in October 1985, had the effect of relieving an immediate financial crisis in Mexico, created by an earthquake in Mexico City and other heavily populated areas, for which there were insufficient reconstruction funds. The Baker Plan contemplated enough advances of new money to provide growth in debtor economies above the level merely required to sustain interest payments on external borrowings. The Baker Plan is credited with enabling bankers and central bankers to have additional time to arrange longer-term solutions to the LDC debt crisis. . . .

The next phase of the LDC debt crisis began in May 1987, when the largest United States bank holding company[, Citicorp,] announced the creation of up to $3 billion of loan loss reserves for LDC debt, about twenty-five percent of its LDC exposure. Within a week, its share value increased $5 per share, about 10 percent of the value prior to the announcement. Other bank holding companies followed suit, including, in all, forty-three of the fifty largest bank holding companies in the United States. The initial round of provisionings occurred because, by year-end 1986, oil prices had fallen so low (about $9 per barrel) that Mexico's foreign exchange reserves (calculated at the last prior new money loan with an assumed price of $15 per barrel) were at negligible levels, the Austral (Argentina) and Cruzado (Brazil) currency reform plans were encountering difficulty, and Brazil suspended foreign exchange interest payments to conserve reserves in February 1987.

During 1987, the amount of loan loss reserves, usually only one or two percent of total loans at the largest banks since 1975, became much larger (three to five percent). This provisioning encouraged market analysts, and most money center banks' shares were traded consistently above book value from the spring until the autumn of 1987, one of the two times since 1974 that this situation occurred. The future exclusion of the LDC loss reserves from primary (Tier 1) capital for supervisory capital adequacy ratios, however, will require additional capital increases for some of the banks involved. . . .

The new loan-loss reserve ratios are surprisingly large, in the historical context. These higher levels of loan-loss reserves are all the more surprising because there are no special tax benefits for creating such large reserves. Under the 1986 tax law, banks' loan loss reserves are deductible from taxable income only to the extent that a bad-debt deduction (charge-off) actually is taken during the same tax year. As of this writing, seven of the ten largest United States banks had only about twenty-five percent of their LDC debt exposure reserved for; two large California bank holding companies and one large Chicago bank holding company were reserved for at least fifty percent of their LDC debt exposures in January 1988.

Foreign banks have not been idle in reserving against LDC exposure, either. Stimulated in part by generous tax allowances for loan loss provisions, continental European banks were between thirty percent and seventy percent reserved (provisioned), including East European and African exposures, as early as mid-1984. Kredietbank of Belgium announced in September 1987 that it would be 100 percent provisioned for LDC exposure by year-end 1987. Japanese and British banks, previously feeling themselves restrained by tax treatment of provisions that was similar to United States tax treatment (no deduction for provisions, but deductions for actual charge-offs), have begun to create special loan loss reserves for LDC exposure. British clearing banks are provisioned to the same general extent (about twenty-five to thirty-three percent of LDC exposure) as United States money center banks.

The round of special LDC loan provisioning initiated in March 1987 has not yet played itself out. More provisioning occurred in December 1987 and January 1988, and still more probably is in store, regardless of any new money loans made in the future, because of ongoing or recurring payments arrears. Brazil, Ecuador, and Argentina have been negotiating with bank creditors in late 1987 and early 1988, and officials are justifiably optimistic that agreements will be reached to provide new money loans to them during 1988, but it should be remembered that those countries have had frequent payments arrears during the 1982-1987 era. . . .

. . . The 1987 special provisions for LDC debt were taken almost entirely from the equity accounts (paid-in common share capital, perpetual preferred shares, and retained earnings or surplus) of the bank holding companies. Temporarily, at least, because 100 percent of the LDC loan loss provisions still count as primary supervisory capital, the primary capital ratios of the bank holding companies have not been weakened, but the common equity ratios are as low as they have been since the early 1980s, typically between two and four percent of total assets, at the largest companies.

Debt-for-equity swaps and securitization of LDC debt are other options frequently mentioned for improving banks' capacity to manage the payments arrears problem on LDC debt. It has been difficult to find acceptable projects for such swaps, but at least a few billion dollars of debt per year should be capable of disposition in that manner. Securitization may offer limited options because institutional investors might have to comply with 'prudent man' fiduciary standards for purchases of packages of LDC debt that did not have third-party guarantees of payment.

Outright secondary market loan sales are another option, although not an option specifically approved for the Baker Plan. Bid prices in the London secondary market (March 1988) for Brazilian (forty-six percent), Argentine (twenty-seven percent), Mexican (forty-eight percent) and Venezuelan (fifty-two percent) debt were at such substantial discounts from face value, in admittedly thin trading, as to suggest that the market questions the eventual repayment capacities, or willingness to pay, of the debtors, notwithstanding any mathematical demonstration of their current or future capacities to pay. . . .

. . . Long-term stretch-outs of maturities in principal, reductions of interest rates below market rates (and even below costs of funds), partial repudiations, extensive accumulations of arrears, partial reductions, cancellations, forgiveness, and the like, probably will increase the longer that the principal value of the LDC debt continues at anything like the current level. Historical and market forces will drive the debt crisis in this direction, even if the United States authorities and the IMF do not.

No matter how it is measured, United States money center banks' exposure to LDCs is greater than the exposure for anyone else. Most of the large regional banks in the United States do not have excessively large, unprovisioned LDC debt exposures, while that exposure still is concentrated and only marginally provisioned for at the money center banks. Even after all the loan-loss reserving and provisioning for LDC debt, and even after retaining seventy percent of earnings for equity accounts, then deducting LDC exposure, Salomon Brothers has estimated that the United States money center banks would be barely solvent, with aggregate net worth of 0.1 percent of assets, while other creditor nations' banks are substantially stronger. . . .

The orthodox IMF three-year austerity cure for LDC overindebtedness is useful in the short term, in the absence of additional external stresses like earthquakes or mudslides, especially for normally profligate debtors with long and deep-rooted traditions of domestic inflation or capital flight. However, it is far from clear that new money lending, on the scale usually proposed in rescheduling and restructuring programs, can be implemented safely by commercial banks. . . .

. . . Thus far, no market-driven solution has emerged that effects a global restructuring of LDC debts. Instead, a series of market alternatives have emerged, each dealing with comparatively small pieces of the total puzzle. For example, active, but still thin, trading in a secondary market for LDC debt of banks emerged in London in 1982 at discounts from par value that currently have a central tendency around fifty percent. The 1988 Morgan Guaranty-Mexico-United States Treasury bonds-for-debt auction is another illustration of market-driven solutions, as are debt-for-equity swaps. Most of such market-driven solutions to the LDC debt problem have been approved by the United States Treasury as acceptable alternatives ('menu options') under the Baker Plan. In any event, the longer that the problem persists without a global solution, the greater will be the number and amount of market-oriented proposals that will surface.

A steady decline in the overall value of LDC debt in the secondary market seems to have set in. The central tendency a year ago (March 1987) was in the sixty percent range, and a year earlier, it was close to seventy percent. If the fairly steady rate of decline persists for two to three more years, which is likely to happen unless debtor economies revive, the markets themselves may create an atmosphere in which general debt reduction or cancellation could flourish because, at twenty to thirty percent of par value, debtor countries themselves might find it a profitable use of foreign exchange to buy in their own debt. Thus, if anything other than a general muddling-through toward a debtor-funded cancellation of the LDC debt in two to three years is to emerge from the present crisis, the necessary reforms must begin to operate now, because there is not much time left. To some extent, Bolivia (eleven percent) and Peru (five percent) already have begun to operate on the "debtor-funded cancellation" principle, and Argentina (twenty-seven percent) and Ecuador (twenty-nine percent) are beginning to reach market price levels at which such cancellations become feasible. . . .

An option frequently discussed, but still resisted by the United States government, is third-party guarantees of LDC debt. Initially, about three years ago, such discussions involved purchase of LDC debt from banks at about ninety percent of par. The secondary market price declines for LDC debt since 1984 have made such proposals distinctly less attractive to both official purchasers and LDC debtors who would have to maintain debt service on the remaining debt. Recent proposals of this type, such as one presented by the chairman of American Express in February 1988, would create a new entity, the Institute of International Debt and Development, a kind of international joint venture funded by sponsoring governments and operated by the IMF and the World Bank, to purchase up to $230 billion of debt from the fifteen countries eligible for the Baker Plan. The proposal assumes that the debt thus purchased can be serviced or sold for at least fifty percent of par value.

NOTES AND QUESTIONS

1. If the banks had anticipated the possibility of an LDC debt crisis before they were already heavily invested in the developing world, what could they have done to adjust their international lending policies to take this risk into account, without losing genuine opportunities for profits?

2. Of the government initiated or sponsored responses to the debt crisis, which ones seem to have been the most effective? The least effective?

3. Do the bail-out techniques described in the Todd article seem likely to be effective? Who pays the price in each case?

4. Is there any way to bail out the debtor government without bailing out the banks?

5. As yet there is little reported litigation regarding the legal implications of the Brady Plan as utilized in specific loan reschedulings and renegotiations. For examples, see *Pravin Banker Associates, Ltd. v. Banco Popular del Peru*, 109 F.3d 850 (2d Cir. 1997) (refusing to delay pending litigation until renegotiation efforts under Brady Plan); *Lloyds Bank PLC v. Republic of Ecuador*, — F. Supp. —, 1998 WL 118170 (S.D.N.Y. 1998) (rejecting argument that 1994 Financing Plan adopted under Brady Plan alters prior obligations of participating states).

6. Why hasn't an overall market-driven solution emerged to effect a global restructuring of LDC debts? Of the market-driven solutions that *have* emerged, which ones seem to have been the most effective? The least effective?

7. The following case turned on the act of state doctrine: Could a foreign bank, which was effectively the instrument of a foreign state, unilaterally restructure its debt owed to, *inter alia*, U.S. banks when the situs of the debt is not the foreign state but the United States? The court ruled it could not.

ALLIED BANK INT'L v. BANCO CREDITO AGRICOLA DE CARTAGO

757 F.2d 516 (2d Cir. 1985)

MESKILL, CIRCUIT JUDGE:

I.

Allied is the agent for a syndicate of thirty-nine creditor banks. Defendants-appellees are three Costa Rican banks that are wholly owned by the Republic of Costa Rica and subject to the direct control of the Central Bank of Costa Rica (Central Bank). Allied brought this action in February 1982 to recover on promissory notes issued by the Costa Rican banks. The notes, which were in default, were payable in United States dollars in New York City. The parties' agreements acknowledged that the obligations were registered with Central Bank which was supposed to provide the necessary dollars for payment.

The defaults were due solely to actions of the Costa Rican government. In July 1981, in response to escalating national economic problems, Central Bank issued regulations which essentially suspended all external debt payments. In November 1981, the government issued an executive decree which conditioned all payments of external debt on express approval from Central Bank. Central Bank subsequently refused to authorize any foreign debt payments in United States dollars, thus precluded payment on the notes here at issue. In accordance with the provisions of the agreements, Allied accelerated the debt and sued for the full amount of principal and interest outstanding.

. . . The sole defense raised by [the Costa Rican banks] in response was the act of state doctrine.

. . . Reasoning that a judicial determination contrary to the Costa Rican directives could embarrass the United States government in its relations with the Costa Rican government, the [district court] held that the act of state doctrine barred entry of summary judgment for Allied. . . .

II.

In our previous decision, we affirmed the district court's dismissal. We did not address the question of whether the act of state doctrine applied because we determined that the actions of the Costa Rican government which precipitated the default of the Costa Rican banks were fully consistent with the law and policy of the United States. We therefore concluded that principles of comity compelled us to recognize as valid the Costa Rican directives. [The court then explained why it now believed that its interpretation of U.S. policy had been mistaken.]

In light of the government's elucidation of its position, we believe that our earlier interpretation of United States policy was wrong. Nevertheless, if . . . the act of state doctrine applies, it precludes judicial examination of the Costa Rican decrees. Thus we must first consider that question.

III. . . .

The extraterritorial limitation, an inevitable conjunct of the foreign policy concerns underlying the doctrine, dictates that our decision herein depends on the situs of the property at the time of the purported taking. The property, of course, is Allied's right to receive repayment from the Costa Rican banks in accordance with the agreements. The act of state doctrine is applicable to this dispute only if, when the decrees were promulgated, the situs of the debts was in Costa Rica. Because we conclude that the situs of the property was in the United States, the doctrine is not applicable.

As the Fifth Circuit explained in *Tabacalera*, the concept of the situs of a debt for act of state purposes differs from the ordinary concept. . . .

In this case, Costa Rica could not wholly extinguish the Costa Rican banks' obligation to timely pay United States dollars to Allied in New York. Thus the situs of the debt was not Costa Rica.

The same result obtains under ordinary situs analysis. The Costa Rican banks conceded jurisdiction in New York and they agreed to pay the debt in New York City in United States dollars. Allied, the designated syndicate agent, is located in the United States, specifically in New York; some of the negotiations between the parties took place in the United States. The United States has an interest in maintaining New York's status as one of the foremost commercial centers in the world. Further, New York is the international clearing center for United States dollars. In addition to other international activities, United States banks lend billions of dollars to foreign debtors each year. The United States has an interest in ensuring that creditors entitled to payment in the United States in United States dollars under contracts subject to the jurisdiction of United States courts may assume that, except under the most extraordinary circumstances, their rights will be determined in accordance with recognized principles of contract law.

In contrast, while Costa Rica has a legitimate concern in overseeing the debt situation of state-owned banks and in maintaining a stable economy, its interest in the contracts at issue is essentially limited to the extent to which it can unilaterally alter the payment terms. Costa Rica's potential jurisdiction over the debt is not sufficient to locate the debt there for the purposes of act of state doctrine analysis. . . .

Thus, under either analysis, our result is the same: the situs of the debt was in the United States, not in Costa Rica. Consequently, this was not "a taking of property within its own territory by [Costa Rica]." *Sabbatino*, 376 U.S. at 428. The act of state doctrine is, therefore, inapplicable.

NOTES AND QUESTIONS

1. Is the *Allied Bank* case correct? Consistent with *Vishipco*? With *Weston?* Would it matter whether or not the loan agreement had the kinds of covenants and waivers of sovereign immunity included in the credit agreement in the Selected Documents Supplement? For background, describing earlier acrimony among the various creditors, see *Step by Step through the Costa Rica Saga*, EUROMONEY, August 1982, at 33.

2. Judge Meskill, the author of the *Allied Bank* opinion, was also the author of the *Garcia* opinion, which was repudiated by the New York Court of Appeals in *Perez*. (*See* note 2, *supra* at [redacted] (discussing *Garcia* and *Perez*).) In *Garcia*, Meskill in effect placed the situs of the deposit obligations exclusively in New York, the location of the headquarters of the depository bank (*i.e.*, the debtor), despite the fact that the bank's Cuban branch was still open when the Cuban Government confiscated Garcia's account. The *Perez* court placed alternate situs in each branch of the depository bank where a deposit could be paid–including its Cuban branch. In *Allied Bank*, Meskill places the situs of the loan obligation due *to* the bank at the bank's headquarters outside of Costa Rica, although the bank's debtor is in Costa Rica. Why does Meskill shift the situs analysis from case to case? Is there any value in the court's effort to define the "situs" of the debt, or is this effectively just a way of avoiding the policy issues? Whether or not you are sympathetic to the analytical approach, do you find the result of the approach reasonable, as you look at the various cases in this chapter?

3. Is the court's treatment of the act of state doctrine wise? Consistent with *Timber-*

lane? For cases going the opposite way on the act of state issue in this context, see *Braka v. Bancomer, S.A.*, 589 F. Supp. 1465 (S.D.N.Y. 1984); *Braka v. Multibanco Comermex, S.A.*, 589 F. Supp. 802 (S.D.N.Y. 1984).

4. Is the *Allied Bank* approach fair among different creditors? Does the result help or hurt a "cooperative adjustment of international debt problems"?

5. Is the case consistent with IMF Article VIII, §2(b)?

6. How important is judicial enforceability in compelling states to pay their debts?

7. Suppose that control and avoidance of the international debt crisis became a basis of controversy between the European nations and Japan on the one hand and the United States on the other. The United States, moved by a combination of laissez-faire economic conservatism and of congressional opposition to bailing out international banks, refuses to support new formal international arrangements. Europe and Japan, however, take a very different view, and urge the banks to form an international cartel to protect themselves against debt default. Under the terms of this cartel–which the banks of the involved states would be only too happy to organize–the participating international banks would agree to help one another in the event that developing states defaults would bring any one of them near bankruptcy. Further, in a much more important and controversial clause, the banks would agree on a common policy of restricting payouts to depositors in the event that this would be the only way for all to avoid bankruptcy. As a lawyer for a U.S. bank, what would you now recommend to your management?

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