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The *Allied Bank* Case and Its Aftermath

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The two principal legal obstacles in collecting sovereign indebtedness in the United States are the defense of sovereign immunity and the act of state doctrine. This article is primarily concerned with act of state problems, in particular as they arose in the context of *Allied Bank International v. Banco Credito Agricola de Cartago*;[1] however, a brief word is in order on sovereign immunity.

I. Sovereign Immunity

In the United States, the law of sovereign immunity has been codified by the Foreign Sovereign Immunities Act of 1976 (the Act).[2] Under the Act, a foreign state, which includes a political subdivision, agency or instrumentality of a foreign state, is immune from the jurisdiction of the courts of the United States and of the States unless one of the statutory exceptions applies. The principal exception in the sovereign lending area is a contractual waiver of immunity which the Act recognizes at Section 1605(a)(1). Since these waiver clauses are standard in commercial bank loans, soveriegn immunity rarely presents a problem for a bank in obtaining U.S. jurisdiction over a sovereign borrower.[3]

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1. 757 F.2d 516 (2d Cir. 1985).

2. 28 U.S.C. §§ 1330 *et seq*. For a general treatment of the defense of sovereign immunity in the context of sovereign lending, see Stevenson, Browne & Damrosch, United States Law of Sovereign Immunity Relating to International Financial Transactions (1983); Nichols, *Sovereign Debtors Under U.S. Immunity Law*, in Sovereign Lending: Managing Legal Risk 81–87 (1984).

3. In the absence of such a waiver clause, the bank lender would have to rely on the "commercial activity" exception provided in 28 U.S.C. § 1605(a)(2), which is discussed in the text following this note.

However, waiver clauses are not commonly found in international bond issues. In such a case, the bondholder would have to rely on the "commercial activity" exception in Section 1605(a)(2) to establish U.S. jurisdiction over the sovereign issuer under the Act. The legislative history of the Act clearly demonstrates that foreign state borrowing, whether in the form of bank loans or bond issues, is a commercial activity within the meaning of Section 1605(a)(2). The problem is that, in order to fit within Section 1605(a)(2), a U.S. lender or bondholder must also establish that: (1) the borrowing activity was carried on in the United States by the foreign state, or (2) the borrowing activity was carried on outside the United States but caused a "direct effect" in the United States. Where the loan is negotiated or the bonds are sold in the United States, or the obligations are payable in the United States, or the lender is a United States person, these requirements should be satisfied and jurisdiction over the borrower/issuer will be sustained.

However, problems may remain in obtaining execution of a judgment obtained against a sovereign borrower or in effecting prejudgment attachment. Section 1610 of the Act governs execution and attachment which, in any event, can only be obtained with respect to property of a foreign state if such property is used in a commercial activity in the United States. In most cases, an explicit waiver of immunity from execution and attachment is also required.[4]

In summary, problems of sovereign immunity can be minimized or even eliminated by carefully drawn waiver clauses in loan agreements or bond indentures. This is not the case with respect to the act of state doctrine, to which we now turn.

II. Act of State Doctrine

A. General

The act of state doctrine is not a principle of international law, but rather is a matter of federal law in the United States. The doctrine was first articulated by the United States Supreme Court in 1897 in *Underhill v. Hernandez*:[5]

> Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.

4. Execution is discussed *infra* at text accompanying note 28.
5. 168 U.S. 250, 252 (1897).

More recently, the Supreme Court in *Banco Nacional de Cuba v. Sabbatino* expressed the doctrine in the context of an expropriation case as follows:[6]

> [R]ather than laying down or reaffirming an inflexible and all-encompassing rule in this case, we decide only that the Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government, extant and recognized by this country at the time of suit, in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, even if the complaint alleges that the taking violates customary international law.

By refusing to pass judgment on the validity of the actions of a foreign state, the act of state doctrine renders non-justiciable claims that challenge such acts, even where United States law is the governing law. The doctrine is subject to a number of exceptions, and only applies where the property affected by the foreign action is within that state's territory.[7] This territorial limitation grew out of cases dealing with the expropriation of foreign assets of U.S. persons, but has recently been applied to breach of contract cases, including default on international loans. The results of applying the act of state doctrine to intangible property have not always been satisfactory.

B. The Facts of Allied Bank[8]

Allied Bank International, an Edge Act corporation, was agent for a syndicate of thirty-nine banks which made certain dollar loans in 1976 to three Costa Rican banks. Each Costa Rican bank was wholly owned by the Republic of Costa Rica and subject to the direct control of the Central Bank of Costa Rica. The three Costa Rican banks executed a series of promissory notes payable to the syndicate banks. The notes were payable in U.S. dollars in New York and contained a submission to jurisdiction in New York. However, there was no provision as to governing law.

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6. 376 U.S. 398, 427 (1964).

7. The draft Revised Restatement of the Foreign Relations Law of the United States of American Law Institute [hereinafter "ALI draft Restatement"], for example, defines the act of state doctrine at Section 469 as follows:

> Subject to a controlling act of Congress or international agreement, courts in the United States will generally refrain from examining the validity of a taking by a foreign state of property within its own territory, and from sitting in judgment on other Acts of a governmental character done by a foreign state within its own territory and applicable there.

For a criticism of the ALI draft Restatement's position on the act of state doctrine, see Halberstam, *Sabbatino Resurrected: The Act of State Doctrine in the Revised Restatement of U.S. Foreign Relations Law*, 79 Am. J. Int'l L. 68 (1985).

8. What follows is only a summary of the relevant facts in Allied Bank. For a complete description of the facts see Zaitzeff & Kunz, *The Act of State Doctrine and the Allied Bank Case*, 40 Bus. Law. 449, 469–471 (1985).

The Costa Rican banks made timely payments under the notes until 1981. In July of that year, in response to deteriorating economic and financial conditions in Costa Rica, the Central Bank issued regulations which essentially suspended all external debt payments. In November, the Costa Rican government blocked all payments of foreign debts in U.S. dollars. As a result of these actions, the Costa Rican borrowers were unable to continue payments on the notes.

Allied Bank thereupon accelerated the notes and, in February 1982, brought suit in the United States District Court for the Southern District of New York.

C. District Court Decision

On July 8, 1983, the District Court issued its decision in favor of the defendant Costa Rican banks.[9] The defendant banks had argued that they could not be sued in the United States under the law of sovereign immunity and the act of state doctrine. The District Court held that the execution of the promissory notes was a "commercial activity" within the meaning of the Foreign Sovereign Immunities Act and therefore the action by Allied Bank was not barred by the defense of sovereign immunity.

However, the District Court sustained the defendants' argument that the act of state doctrine prevented recovery in this case. In the words of District Court Judge Griesa:[10]

> A judgment in favor of Allied in this case would constitute a judicial determination that defendants must make payments contrary to the directives of their government. This puts the judicial branch of the United States at odds with policies laid down by a foreign government on an issue deemed by that government to be of central importance. Such an act by this court risks embarrassment to the relations between the executive branch of the United States and the government of Costa Rica.

There was no discussion of the situs of the indebtedness or its relevance to the applicability of the act of state doctrine to Allied Bank's suit on the notes.

While the action was still pending before the District Court, the parties began to negotiate a rescheduling of the outstanding debt. In September 1983 these negotiations came to fruition as the defendant banks, the Central Bank and the Costa Rican government signed a refinancing agreement with the coordinating agent for Costa Rica's external creditors. Fidelity Union Trust Company of New Jersey, one of the members of the thirty-nine-bank syndicate, refused to accept the agreement. Accordingly, Allied

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9. 566 F. Supp. 1440 (S.D.N.Y. 1983), *rev'd,* 757 F.2d 516 (2d Cir.), *cert. dismissed,* 106 S. Ct. 30 (1985).

10. 566 F. Supp. at 1444.

brought an appeal to the United States Court of Appeals for the Second Circuit on behalf of Fidelity, the sole dissenting bank.[11]

D. The Initial Second Circuit Decision

On April 23, 1984, the Second Circuit affirmed the decision of the District Court.[12] The plaintiff had argued on appeal that the act of state doctrine was inapplicable because the situs of the defendants' obligations was outside Costa Rica, *i.e.*, in New York. The Second Circuit held that the location of the debts was not determinative of the outcome of the suit. In the view of the Second Circuit, even if the property or contractual obligations affected by the foreign government's actions were located within the United States, the court would give effect to such actions if "they are consistent with the policy and the law of the United States."

Drawing an analogy between Costa Rica's rescheduling of its external debts and a reorganization pursuant to Chapter 11 of the U.S. Bankruptcy Code, the court found that Costa Rica's actions prohibiting payment of external debts was consistent with U.S. law and policy. The prohibition of debt payments was, in the court's view, similar to a stay on actions to collect a bankrupt's debt pending the reorganization of the debtor. Further, Costa Rica's renegotiation of its debts was consistent with U.S. foreign policy as evidenced by support for these renegotiations from the legislative and executive branches of the U.S. government.

The Second Circuit's opinion created shock waves throughout the U.S. international banking community. Since the Second Circuit was relying on "comity" considerations rather than traditional act of state principles, it would no longer be possible for banks to structure their loan agreements to assure that the situs of the debt would be outside the foreign country of the debtor.[13] Thus, there could be no certainty that at some future date payment of the debt would not be blocked by the imposition of exchange controls as part of a rescheduling effort sanctioned or favored by the U.S. government. The plaintiff had sought a reversal on act of state grounds, but instead was on the receiving end of an opinion which considerably expanded the act of state doctrine and called into question the legal enforceability of foreign indebtedness.[14]

11. The refinancing nevertheless became effective and the Costa Rican banks have been making payments to the remaining 38 members of the syndicate.

12. 733 F.2d 23 (2d Cir. 1984) (not published in the bound edition of F.2d), *vacated*, 757 F.2d 516 (2d Cir.), *cert. dismissed*, 106 S.Ct. 30 (1985).

13. This could be done by having all payments made in New York, a submission to jurisdiction in New York, and a New York governing law clause.

14. One immediate consequence of the Second Circuit's decision was to require law firms representing banks making international loans to reconsider their legal opinions and in many instances to qualify these opinions.

E. Intervention of United States Government

The plaintiff filed a petition for rehearing of the Second Circuit's April 1984 decision. The U.S. Department of Justice filed a brief as *amicus curiae* in support of the petition for rehearing. The Justice Department contended that the case should be reheard because the Second Circuit's opinion was "based on a misunderstanding of the policy of the United States on a matter of major consequence."

The government used its brief to clarify its position on the role of private debt in the debt restructuring process:

> [T]he United States Government is concerned that this process will be jeopardized by the Court's decision in this case. In particular, an important element in the functioning of this process has been the willingness of commercial banks to reschedule debt and to provide credit to countries undertaking adjustment efforts. The confidence of lenders in the enforceability of their loan agreements payable in New York is critical to their willingness to extend international credit.
>
> However, this Court's opinion introduces significant uncertainties into the process of making and interpreting international financial agreements, leaving unclear, to debtors and creditors alike, the circumstances under which United States courts will give effect to a foreign government's actions limiting payments of obligations in the United States. Consequently, the United States Government believes that the Court's opinion may well discourage commercial lenders from providing essential new financing and could adversely affect the taking of adjustment measures. If these developments were to occur, the orderly resolution of debt problems could be seriously jeopardized.

On the basis of this new information, the Second Circuit granted a rehearing and ultimately reversed its initial decision in the case. For the rehearing, the U.S. Government submitted a very strong *amicus curiae* brief making the same policy argument and further contending that the act of state doctrine should not be applied to dismiss Allied Bank's suit. The Departments of State, Treasury and Justice, and the Federal Reserve Board joined in the brief. The intervention of the U.S. government in this litigation effectively turned the tide in favor of the plaintiff.

F. Second Circuit Decision on Rehearing

On March 18, 1985, the Second Circuit announced its long-awaited decision on rehearing: The District Court was reversed and the case was remanded for entry of summary judgment in favor of Allied Bank![15] The court admitted that, in light of the government's elucidation of its position, its earlier interpretation of U.S. policy was wrong.[16] The Second Circuit was now persuaded that Costa Rica's unilateral restructuring of its private

15. 757 F.2d 516 (2d Cir. 1985).
16. *Id.* at 520.

debt obligations was inconsistent with U.S. policy in this area. Thus, unlike its previous decision which was based upon international comity, it was necessary to examine defendants' act of state defense.

The court reviewed recent act of state cases, giving particular emphasis to the foreign policy considerations which provide the rationale of the doctrine. These foreign policy concerns have led courts to limit the doctrine to acts of a foreign state within its own territory.[17] Thus, if the situs of the indebtedness affected by the Costa Rican government actions was outside Costa Rica, the act of state defense would not apply. Given the fact that the debt was payable in dollars in New York and the defendant banks agreed to jurisdiction in New York, the court found that the situs of the obligations was not Costa Rica, but New York.[18]

However, the Second Circuit was not finished: It reiterated that acts of foreign governments having extraterritorial effect could still be recognized by a U.S. court if "they are consistent with the law and policy of the United States."[19] Since Costa Rica's unilateral attempt to repudiate its private, commercial debts is inconsistent with (1) the orderly resolution of international debt problems, (2) the interests of the United States, a major source of private international credit, and (3) principles of contract law, the Costa Rican directives should not be given effect.[20] The court had come full circle from its comity analysis with which it began its opinion.

Since there were no material questions of fact and the act of state defense was the sole defense raised by the Costa Rican banks, the court granted plaintiff's motion for summary judgment. A complete victory for Allied Bank!

III. Summary and Conclusion

A. Current State of the Law

Where does the law stand after *Allied Bank*? At least in the Second Circuit, courts will apply a three-step test in deciding whether to dismiss an action to enforce a foreign debt:

17. *See supra* note 7. *But cf.* Rosenthal, *Jurisdictional Conflicts Between Sovereign Nations*, 19 INT'L LAW. 487, 499 (discussing International Association of Machinists v. Organization of Petroleum Exporting Countries, 649 F.2d 1354 (9th Cir. 1981), *cert. denied*, 454 U.S. 1163 (1982)). In the OPEC case, the activity at issue occurred outside the territories of the states whose actions were at issue, but the property involved (oil) was located within the territory of the states.

18. 757 F.2d at 522.

19. *Id.*

20. *Id.*

(1) If the borrower is a foreign state or a state-owned agency or corporation, is the suit barred under the law of sovereign immunity?

(2) If not, is the suit barred under the act of state doctrine? In applying the act of state doctrine, courts will continue to determine the situs of the property affected by the actions of the foreign state, and, if the property is located outside the territory of such state, the doctrine may not be invoked.[21]

(3) If the act of state doctrine is not deemed to be applicable because the plaintiff's property is located outside the territory of the foreign state, the actions of such state may still be recognized and given effect in U.S. courts if the actions are consistent with U.S. law and policy.

Regarding the second step described above, it should be noted that the Second Circuit has now confirmed the "traditional" approach toward applying the act of state doctrine to intangible property such as contract rights and promissory notes. Under this approach, the situs of an obligation is determined by ascertaining where the obligee's (*i.e.*, lender's) rights may be enforced. In *Allied Bank*, the Costa Rican banks had agreed to repay their debts in dollars in New York and had submitted to the jurisdiction of courts in New York. Even in the absence of a New York governing law clause, the Second Circuit was able to conclude that the situs of the debt was outside Costa Rica because the debt was enforceable in New York. Thus, the act of state doctrine did not apply. In effect, the court was saying that Costa Rica's exchange control laws would not be given extraterritorial effect.

One may question whether such a traditional territorial approach is the appropriate one in the case of intangible property rights. The territorial limitation on the act of state doctrine arose out of cases dealing with expropriation of fixed assets and makes sense in this context. Why should a U.S. court give effect to the expropriating act of a foreign state where the property is located in the United States or some third country?[22]

However, there appears to be less justification for applying a territorial limitation to intangibles. The situs of an intangible property right is somewhat artificial, and courts using this test seem to have lost sight of the policy considerations underlying the act of state doctrine. Wouldn't a more sensible approach be to apply the doctrine to these contract rights only

21. There may, of course, be other reasons for not applying the act of state doctrine such as the absence of a foreign relations concern or the availability of one of the common law or statutory exceptions.

22. In fact the second Hickenlooper amendment presently bars application of the act of state doctrine with respect to property located within the United States where the act of expropriation violates international law. 22 U.S.C. § 2370(e)(2). *See* ALI draft Restatement, *supra* note 7 § 470.

where foreign policy considerations dictate such a result, regardless of the situs of the intangible?

B. Comity Considerations

Step three noted above demonstrates that the "comity" approach of the Second Circuit's initial decision has not been extinguished. In fact, it seems reasonably clear that on rehearing the Second Circuit was not denying comity as a consideration, but was merely saying that its previous decision on comity was wrong, *i.e.*, the actions of the Costa Rican government were *not* consistent with U.S. interests and, therefore, comity did not prevent the court from deciding the case. This leaves open the possibility that at some future date comity may be used as a justification for giving effect to foreign exchange controls or some other foreign governmental action where such action *is* consistent with U.S. law and policy. For example, the U.S. government may have encouraged a foreign country to reschedule its debts and could advise the court that unilateral action by creditor banks in collecting these debts would be disruptive to the orderly rescheduling process. Thus, comity cannot be entirely ruled out as a factor in these cases.

C. IMF Article VIII 2(b)

Another cause for future concern is Article VIII 2(b) of the IMF Articles of Agreement.[23] Article VIII 2(b) reads 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.

For some reason, this provision was not an issue in the *Allied Bank* case. However, if a court determined that (1) a loan agreement or a promissory note was an "exchange contract," and (2) an exchange control regulation of a member state was maintained or imposed consistently with the IMF Articles of Agreement, then a loan agreement or promissory note which is contrary to such exchange control regulation would be unenforceable. The IMF has never defined the meaning of the term "exchange contract," and the weight of authority in the United States and the United Kingdom favors a narrow definition of this term which would *exclude* loan agreements and promissory notes. On the other hand, there is authority on the continent of Europe which defines exchange contract to

23. International Monetary Fund Articles of Agreement, amended, Apr. 30, 1976, 29 U.S.T. 2203, T.I.A.S. No. 8937.

include financial agreements.[24] Accordingly, while Article VIII 2(b) does not presently pose a significant threat to the enforceability of international loan agreements in U.S. courts, it may at some future date become an obstacle if courts adopt the more expansive definition of exchange contract.[25]

D. The Execution Problem

Finally, there is the problem of execution against a foreign state alluded to at the beginning of this article. Put in concrete terms, now that Allied Bank has a judgment, how does it collect from the Costa Rican banks? Has it won the battle but lost the war?

The rules relating to immunity of property of a foreign state from attachment in aid of execution or execution upon a judgment are set forth in Section 1610 of the Foreign Sovereign Immunities Act of 1976.[26] In relevant part, Section 1610(a) denies immunity only if:

(1) the property is used for a commercial activity in the United States, *and*

(2)(a) the foreign state has waived its immunity from attachment or execution either explicitly or by implication, *or*

(b) the property is or was used for the commercial activity upon which the claim is based.

If the debtor is a foreign agency or instrumentality engaged in commercial activity in the United States, somewhat broader grounds for attachment or execution are available under Section 1610(b).

These rules will make it difficult for a bank or other creditor to enforce a judgment against a foreign state in the United States. Even where the loan agreement or promissory note contains an explicit waiver of immunity from attachment or execution, such attachment or execution may only be available against commercial property located in the United States. But this problem pre-dates the *Allied Bank* case and is properly the subject of another article.

24. For a discussion of the law in this area, see J. Gold, The Fund Agreement in the Courts, (1982).

25. Even if courts adopt an expansive definition, one may question whether Article VIII 2(b) should be applied retroactively to render unenforceable a loan agreement which was legal, valid and binding on signing, i.e., should the subsequent imposition of exchange controls be given effect under Article VIII 2(b)?

26. 28 U.S.C. § 1610.