RECENT DEVELOPMENTS

REHEARING GRANTED: ALLIED BANK INTERNATIONAL V. BANCO AGRICOLA CREDITO DE CARTAGO AND THE CURRENT INTERNATIONAL DEBT CRISIS

I. INTRODUCTION

The United States District Court for the Southern District has ordered a rehearing of the ruling in *Allied Bank International v. Banco Agricola Credito de Cartago*[1] (*Allied*). This is well received news in the banking community because the magnitude of foreign

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1. 566 F. Supp. 1440 (S.D.N.Y. 1983). Allied brought the action as an agent for a syndicate of thirty-nine banks (United States and foreign) to recover on promissory notes issued in connection with loan agreements. The debt was, by the terms of the instrument, payable in New York City. The instrument was in default. The case was dismissed by the district court due to a Costa Rican governmental decree setting out a moratorium on the payment of foreign debts. The court held that repayment was precluded under the act of state doctrine. Rescheduling of Costa Rica's obligations took place while the action was pending in the district court. Fidelity Union Trust Company of New Jersey, a member of the syndicate, declined to enter into a new agreement with the other participants. As the only member not entering into a new agreement, the appeal went forward on behalf of Fidelity Union Trust Company. A decision was handed down on April 23, 1984, where a panel of the court affirmed the district court's dismissal without addressing the act of state doctrine but rather by stating that the actions of the Costa Rican Government that precipitated the default are consistent with United States laws and urging that comity requires the Costa Rican action to be effective in the United States courts. A rehearing was granted on July 3, 1984, and the court was scheduled to begin the case in September 1984. *Contra* Libra Bank Ltd. v. Banco Nacional de Costa Rica, 570 F. Supp. 870 (S.D.N.Y. 1983). The facts of *Libra Bank* are very similar to those of *Allied Bank*. *See infra* note 3. The court in *Libra Bank* recognized that there was merely an attempt by a foreign sovereign to avoid payment of a debt that it concededly owed to its creditors. The court found that although a debtor may be sued at the creditor's choice in either of the two jurisdictions, the legal incidents of the debt may place it in the United States for the purposes of the act of state doctrine. *Id.* at 881. The court concluded that "a United States court may still find that the situs of the debt was in the [United States] at the time of the attempted confiscation." *Id.*

The reason for the banning of the act of state doctrine is more easily recognized when the reasonable expectations that underlie the territorial limitation are brought to light. In conclusion, the key elements were: (1) Banco Nacional contracted to repay the loan in New York City; (2) it consented to jurisdiction of U.S. courts; (3) it waived its sovereign immunity with respect to legal proceedings concerning the debt; and (4) it continued to maintain assets in the U.S. *Id.* at 884.

The court considered that because the act of state was incomplete at the time of the attempted confiscation, and that the bank had assets in the U.S., the act of state was incomplete with the acquiescence of the U.S. *Id.* (citing Maltina Corp., 462 F.2d at 1028.) Considering these points it could hardly be said that the foreign sovereign had a reasonable expectation of dominion over the legal rights involved in the dispute. *Id.*

debt, especially to Latin and South American countries, is at an all time zenith. The early 1970's evidenced an unprecedented American growth in banking when United States banks expanded their international operations.[2] The potential for future loan activity may be affected to a considerable extent, depending on how *Allied* is decided upon rehearing.[3]

The current international debt crisis is among the most critical problems on the world economic agenda. The figures are astronomical: the total debt load for the lesser developed countries (LDC's) exceeds $750 billion.[4] Of this amount over one-half is owed

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2. The increase in lending activity by major U.S. banks occurred when markets perceived to offer excellent opportunities improved due to the changing world economic situation. While numerous factors contributed to the growth of international lending by U.S. banks, Arthur F. Burns of the Federal Reserve Board cited three major reasons: "first, the enormous use of financing needs around the world that was occasioned by the quituplicy of oil prices; second, the willingness of American banks to respond to those financing needs; third, the growth of multinational corporations and the internationalization of banking through the Eurocurrency markets." *International Banking Operations: Hearings Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Housing Committee on Banking. Finance and Urban Affairs*, 95th Cong., 1st Sess. 60 (1977). Bank activity increased in, among other areas, the Latin American countries and their governmental instrumentalities. Generally, the foreign government will desire a level of financing well beyond the capabilities of a single institution. To service this need, a lending syndicate is organized by a major bank that will take the position as the syndicate manager. For a thorough discussion on lending syndicates, *see generally*, Clarke & Farrar, *Rights and Duties of Managing and Agent Banks in Syndicated Loans to Government Borrowers*, 1 U. OF ILL. L.R. 229 (1982).

3. In *Allied*, the inquiry reached the point of whether the Costa Rican directives instructing Banco Credito de Cartago not to pay its loan obligation fell within the purview of the act of state doctrine. 566 F. Supp. at 1443. The court followed the circuit court case of Texas Trading & Milling Corp. v. Federal Republic of Nigeria, 647 F.2d 300, 316 n. 38 (2d Cir. 1981), *cert. denied*, 454 U.S. 1148 (1982). At that point *Allied* departed from *Libra Bank*, 570 F. Supp. 870, where it stated that the crucial factor in the instant case was the conduct of the Costa Rican Government that prevented the payment of the loans through its decrees. The court did not want to put the judicial branch of the United States at odds with the Costa Rican Government, and through such action risk embarrassment to the relations between the executive branch of the United States and the Costa Rican Government. The court concluded by stating that the act of state doctrine bars the summary judgment motion of Allied and clearly such a "defense dictates denial of Allied's motion." 566 F. Supp. at 1444. Therefore, the state of the law on the question of the act of state doctrine, sovereign immunity, and the Foreign Sovereign Immunities Act is an open question where on identical facts, the *Libra Bank* and *Allied Bank* courts arrived at opposite conclusions. The upcoming rehearing will either solidify the court's position or leave the question open for the future.

4. *The International Debt Threat: A Way to Avoid a Crash*, ECONOMIST, Apr. 30, 1983, at 11. In 1982, Western banks had in excess of $180 billion loaned to Latin America. It has become evident that large banks became locked into their foreign loans. The withdrawal of an individual bank from any given country would very likely bring the country's downfall as well as the bank's insolvency. *Id.* The exposure of ten leading American banks should help to illustrate the magnitude of the problem:

to commercial banks.[5] The strain on the economic system is evidenced by the fact that twenty-five countries with bank loans of approximately $250 billion have been forced to reschedule their debts.[6] This huge debt load is a result of structural imbalances[7] in the various countries' external payments as a result of the first oil crisis in the early 1970's.[8] The oil price hike presented the oil importing LDC's with the choice of imposing abrupt deflation on their economies or to run increased current-account deficits. These deficits would eventually be covered by huge borrowings from the international banking community.

The commercial banks seized the opportunity to derive a profit by reloaning the savings of the Organization of Petroleum Exporting Countries (OPEC) to the LDC's where the demand for capital was large. While recycling OPEC surpluses to the LDC's was considered a workable plan, Western governments did not envision an official role for themselves in the regulation of the recycling of the

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Outstanding Loans
($ billion)

	(1) Brazil	(2) Mexico	(3) Venezuela	Tot. of Col. 1-2-3	Tot. as % of Bk's equity
Citicorp	4.4	3.3	1.1	8.7	180
Bank of America	2.3	2.5	2.0	6.8	148
Chase	2.4	1.7	1.0	5.1	183
Man. Hanover	2.0	1.7	1.1	4.8	174
Morgan Guaranty	1.7	1.1	0.5	3.3	122
Chemical	1.3	1.5	—	2.8	143
Bankers Trust	0.9	0.9	0.5	2.2	143
Cont. Illinois	0.5	0.7	0.5	1.6	96
First Interstate	0.5	0.7	—	1.2	64
Security Pacific	0.5	0.5	—	1.0	68

Id. at 13 (citing AM. BANKER).

5. *Id.* Rescheduling of loans has become a normal practice in international loans. The typical scenario includes International Monetary Fund (IMF) involvement. The IMF, generally, puts economic conditions on its loans. Such conditions typically call for severe domestic austerity that tend to squeeze economic growth and precipitate bankruptcies in the private sector. A typical IMF strategy would include freeing up interest rates, cutting budget deficits, and frequent minor currency devaluations to maintain competitiveness in agriculture and industry. While growth falls off, the squeeze is intended to produce a trade surplus that can be applied to debt servicing. *See generally The Crash of 198?*, ECONOMIST, Oct. 16, 1982, at 23.

6. *See The International Debt Threat: A Way to Avoid a Crash, supra* note 4.

7. *Id.* at 11.

8. *Id.*

funds.[9] The foundation for the massive lending was based on the capital and resources of the principle Western banks and not upon the developed world's resources.[10]

II. THE POSITION OF THE UNITED STATES

The United States recognized the potentially grave impact that the *Allied* decision could stir among the international banking community. In its brief as *amicus curiae* in support of the petition for rehearing and suggestion for rehearing *en banc*, the United States noted that the "decision (in *Allied*) is based on a misunderstanding of the policy of the United States on a matter of major consequence. . . ."[11] The United States submitted that in "holding that

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9. *The International Debt Threat: A Concerted Way Out*, ECONOMIST, July 9, 1983, at 14.

10. *Id.* The New York banks committed themselves to the largest share of the loans, acting as the main money-center institutions of the world banking system. The money-center banks acted directly to the borrowers as well as indirectly to the interbank system. The money-center banks made a surplus pool of funds available to smaller banks or to foreign banks that were unable to directly attract deposits denominated in foreign currency. Naturally, these smaller institutions in turn began to lend these funds to the LDC's where the money-center banks recognized the potential for handsome returns. In effect, the American money-center banks were further exposed due to the smaller banks' lending activities to the LDC's. This chain of events precipitated the world banking community's current problem. It is interesting to note that there is no limitation over the end use of funds after they are channelled through to the intermediate banks. Apparently, these banks should make an independent analysis of the risk of the situation. But, the evidence points to a desire to reap large profits by joining the massive lending spree to the LDC's. *See generally The International Debt Threat: A Way to Avoid a Crash, supra* note 4, at 11. The American banks were not the only institutions involved. This large financial commitment applies to the leading British, German, and Japanese banks. These money-center institutions are large banks that act as primary depositories of surplus funds. The American authorities did not discourage these developments and, actually, the Treasury viewed it as proper intermediation of the market place in the supply and demand of money. The Federal Reserve applauded the dependence on American banks in this situation as a tool of strength for American policy. *Id.* The institutions that carried out their lending operations through the Euromarkets to country and other borrowers apparently assumed that the American monetary authorities would act as lenders of last resort if there were a liquidity shortage in the Euromarkets. *Id.* at 12. There are three major reasons why the non-American banks would believe that the American monetary authorities would act as lenders of the last resort:

> (1) Three-fourths of the outstanding international debt is denominated in U.S. dollars;
> (2) The primary provider of these funds for the credits were advanced by American banks. Ergo, the implication arises that if a foreign bank can not meet its obligation to American banks, then the Federal Reserve will step-in to meet the shortfall; and
> (3) The Federal Reserve is perceived to have adopted a policy of neglect during the expansion of international lending by the American banks. The prevailing European belief is that such neglect was an expression of tacit knowledge and approval of the situation.

Id.

11. Brief for the United States as *amicus curiae* at 2, Allied Bank Int'l v. Banco Credito

Costa Rica law was consistent with the policy of the United States, the panel did not have before it the views of the United States, and the panel's decision is based on an inaccurate understanding of the policy of the United States."[12] The court's determination of the United States policy was based, in part, on the United States support of loan renegotiation by the legislative and executive branches of government.[13] Under the circumstances of *Allied*, United States policy dictates that the courts should enforce a private commercial loan contract on which the suit is brought in the United States.[14] The court's determination, based on incorrect perceptions of United States policy, should not suggest "that Costa Rican debt to private creditors should be rendered unenforceable by virtue of actions of the Costa Rican Government to which the creditors did not agree."[15]

United States policy with reference to private debt agreements seeks to encourage voluntary participation of private lenders in the restructuring process.[16] The United States recognized that an "orderly resolution is crucial to the stability and future growth of the world and the U.S. economy."[17] A five-point strategy has been

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Agricola de Cartago, 566 F. Supp. 1440 (S.D.N.Y. 1983) [hereinafter cited as United States Brief].

12. *Id.* at 1.

13. *Id.* The United States concluded that the court developed this incorrect interpretation of policy "upon certain actions of the executive and legislative branches" of the government. *Id.* The certain actions cited were the President's certification to Congress under the Foreign Assistance Act of 1961 (FAA), a concurrent resolution of the House of Representatives, and a Paris Club Agreed Minute. The President's certification of the FAA dealt with the continued U.S. assistance despite the fact that Costa Rica was in default on loans extended by the U.S. under the Act; these were not commercial debts. As a multilateral agreement among creditor nations, the Paris Club Agreed Minute was an understanding among those nations to recommend common terms for a bilateral restructuring of Costa Rica's debts extended by participating governments. The Minute does, though, recommend that Costa Rica seek to restructure private debts on comparable terms. *Id.* at 4. *See also* The Wall Street Journal, Sept. 12, 1984, at 36, col. 5. The IMF and Costa Rica are close to an agreement on a loan-adjustment program to aid repayments on its $1.4 billion debt to commercial banks. *Id.* The concurrent resolution of the House of Representatives was a general sympathetic statement in reference to Costa Rica's economic crisis. United States Brief at 4.

14. United States Brief, *supra* note 11, at 3.

15. *Id.* at 4.

16. *Id.* The United States realized the possible repercussions of a debt collapse and the participation of private lenders in the restructuring of private debts is a key element of U.S. "policy designated to facilitate the orderly resolution of the difficult debt service problems faced by a considerable number of developing countries." *Id.*

17. *Id.*

supported by the United States to deal with the debt service problem:

> (1) The implementation of economic adjustments by borrowing countries designed to stabilize their economies and restore sustainable external positions;
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> (2) An International Monetary Fund (IMF) adequately equipped to help borrowers design adjustment programs and provide balance of payments financing on a temporary basis while adjustment programs take effect;
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> (3) Readiness of monetary authorities in creditor countries to provide short-term liquidity support, when essential to assist selected borrowers that are formulating adjustment programs with the IMF;
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> (4) Encouragement to private markets to provide prudent levels of financing to borrowing countries in the process of implementing IMF-supported adjustment programs; and
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> (5) Resumption of sustainable, non-inflationary economic expansion and maintenance of open markets, both in the industrial countries and in developing countries facing debt problems.[18]

Though the debt problem has been "managed with reasonable success,"[19] the United States showed concern that the progress might be halted by the court's decision. A pivotal element in the process has been the "willingness of commercial banks to reschedule debt and to provide credit to countries undertaking adjustment efforts."[20] Lender confidence in the "enforceability of their loan agreements payable in New York is critical to their willingness to extend international credit."[21] The uncertainty that has been introduced into the process of "making and interpreting international financial agreements, leaving unclear . . . the circumstances under which United States courts will give effect to a foreign government's actions limiting payments of obligations in the United States"[22] may

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18. *Id.* at 4-5.
19. *Id.* at 5.
20. *Id.*
21. *Id.* at 5-6.
22. *Id.* at 6. The United States continued to enumerate what the court's decision suggests a foreign sovereign borrower might have to demonstrate to a United States court to abrogate its obligations:

well discourage further commercial bank cooperation in providing new financing and taking adjustment measures.[23] This would clearly jeopardize an orderly resolution of the debt situation.[24] It has been

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> (i) a good faith desire to reschedule its debts, (ii) the temporary nature of the deferral or prohibition on payments, (iii) the concurrence of most of its creditors, (iv) a rescheduling of its public sector debt, (v) compliance with its own laws, (vi) that the law applicable to the debt is foreign law, (vii) the endorsement of its efforts by a resolution of one or both Houses of Congress, or (viii) a shortage of foreign exchange.

Id.

23. *Id.*

24. *Id. See also* The Wall Street Journal, *supra* note 13. For a practitioner's guide to defaults in the international forum, *see* Ryan, *Defaults and Remedies under Internation Bank Loan Agreements with Foreign Sovereign Borrowers—A New York Lawyer's Perspective*, 1 U. OF ILL. L.R. 89 (1982). A loan agreement specifies that in the event of default, the syndicate has the right to end the lending relationship. This right includes declaring the outstanding loan due and payable. It is emphasized that this is a drastic step, one which a syndicate will rarely exercise unless it is deemed the last resort when all other possibilities have been exhausted. A syndicate will generally try to reschedule loans, obtain collateral, or obtain a guarantee as a method of dealing with a delinquent borrower. *Id.* at 90. While the remedies available to a banking syndicate are numerous, in reality, a banker will endeavor to cure a default by renegotiating the loan. Once a loan has been defaulted upon, there has to be a write-off against the bank's capital and reserves. This is not a popular occurrence due to the downward effect it has upon the bank's profitability. It is interesting to note that, traditionally, credit-worthiness of a customer is a primary consideration for the lending institution to base its loan decisions on. As competition increased, however, the once cautious bankers rationalized their past actions to justify the increasing dependence of their institutions on the profits from their international loan portfolios. *See generally The International Debt Threat: A Way to Avoid a Crash, supra* note 4, at 11. Loan maturities had a minimal role in the structure of a country's requirements. Loans were "packaged" in terms of their magnitude and maturity either to meet market preferences or to fit the spread over the London Interbank Offered Rate (LIBOR) that the borrower countries were intending to pay. Although the spreads represented a small proportion of the total cost of borrowing, some bankers managed to transform this into an ad hoc credit-worthiness rating. Often, the loan maturities had to be shortened to fit the LIBOR spread expectations. *Id.* The situation evolved to where demand rather than supply dictated the ultimate size of the debt pool. *Id.* at 12. The mobilization of the short-term deposits and credit availability was accomplished through a system where lenders entered into a commitment to supply funds for a stated period without matching it with deposits of comparable maturities. This scheme allowed the banks to make periodic revisions in their interest rates at 3 or 6 month intervals. Because their interest rates are based on the cost of money to themselves plus an appropriate spread, the bank can borrow for each loan and thus refinance the amount that was originally loaned to the borrowers. *Id.*

The notion that short-term loans were safer than long-term loans caused additional difficulty. *Id.* at 12. Lenders believed that a shorter maturity would allow them to recover their assets more rapidly than the other creditors. The market place was reluctant to respond to the borrowers' demand for long-term credit, and with the ultimate power residing with the lenders, loan maturities became shorter to fit the lenders' preferences. *Id.* The ultimate result evidenced huge sums of borrowing becoming bunched to the point where a justified concern existed in reference to refinancing existing debt that was due for payment, as well as being able to secure new credit for further capital requirements. *Id.* at suggested that a major bank default would radiate a financial shock that would echo throughout Wall Street, sending the price of gold skyrocketing and setting off political chaos in the defaulting

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12. These arrangements, in concert with the world economic situation, have led to a banking crisis. Apparently, the events that transpired were not envisioned by the numerous banking institutions that had become involved.

While the reasons for the economic difficulties in Latin American countries vary, the general theme is one of overly ambitious economic growth. In Mexico, for example, the two major causes reside with the huge increases in public spending, post-1978, by the Portillo government, and the decision to keep the peso overvalued in an effort to slow down the inflationary effect of the public spending. Unfortunately, the end result was a massive trade deficit. To cope, short-term borrowing was employed to wrestle with the trade deficits and public spending. By February, 1982, the government was forced to devalue the peso in an effort to stimulate trade. Six months later, the U.S. provided Mexico with more than $6 billion in loans while Mexico announced that they would negotiate a debt restructure with the IMF. The eventual nationalization of the banks and the imposition of exchange controls that banned the importation or exportation of currency managed to force private capital out of Mexico instead of locking it in. Domestic savings collapsed due to the negative real interest rates.

It is important to compare the plight of Brazil with that of Mexico. Brazil's problems stem from the price of oil and its increase. Beyond that, many of the funds not compensating for the trade deficit did go to various projects having economic justification. While Brazil is considered to be a more responsible borrower than Mexico, its debt has risen to the magnitude of $90 billion. It is doubtful that Brazil will ever pay back at 100 cents on the dollar, with interest, what it owes to foreign banks, exporters, and governments. There is also further concern of its domestic government debt that trebled in 1982. To add to this problem, productive investment is down while capital goods imports fell by 16% in 1981 and an additional 10% in 1982. An increase in exports and a drop in world interest rates are necessary elements for Brazil's recovery.

Argentina's military government that took power in 1976 brought a certain stability to an economic mess. The austerity exercised on the domestic sector helped transform a trade deficit into a large surplus with an accompanying drop in inflation from 600% to 50% annually. The military government joined in the Latin American borrowing spree leading to an increase in government spending with the inevitable rise in inflation. The government attempted to hold inflation by revaluing the peso to reduce import prices. The end result was an increased trade deficit. The government next tried to cut back at the domestic level forcing unemployment to 13% from 3% (the 1978 low) and, in turn, causing unrest among the trade unions and political parties. While the Falkland invasion of April, 1982, drew the people together, this unity was short-lived when the war was lost and the heavy costs of a military venture were paid.

While the circumstances surrounding these three borrowing countries are varied, the bottom line is that the aggregate sum of their debt may very well exceed their ability to repay their creditors. *See generally*, Gall, *Games Bankers Play*, FORBES, Dec. 5, 1983, at 172; *The International Debt Threat: A Way to Avoid a Crash*, ECONOMIST, April 30, 1983, at 11. The funds currently being placed into the LDC's are not being utilized for long-term capital investment, but rather for the servicing of existing debt. Clearly, this arrangement is being undertaken to prevent a shock to the world's banking system. If Mexico, Brazil, Argentina, and Venezuela default on their outstanding loans, certain key American banks would collapse. *See supra* note 4, (consider the outstanding loans of key American banks to Latin American countries as a percentage of the bank's equity). The collapse of the American banks would be a solvency rather than a liquidity problem. Banks lend funds for longer periods countries.[25] Additionally, the hope for a world economic recovery would be quashed for the near future.[26]

III. THE NEW YORK CLEARING HOUSE POSITION

The New York Clearing House Association[27] also filed a brief *amicus curiae* to urge the court for a rehearing. The Clearing House Association noted that unless *Allied* is set aside, such a decision may have the following effects on international banking:

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than they borrow. This is one method employed to make money; it is termed transforming maturities. It is clear that a bank could not repay all of its depositors at once, when its obligations are due, without getting help from its central bank or suffering large losses. An example would be a typical "rush" on a bank where depositors become nervous and attempt to pull out their assets. This leads to a liquidity problem.

The American banks face a solvency problem in Latin America. As a bank's bad debts (loans which will never be repaid) increase, a point is reached when the losses must be written off against the bank's capital and reserves. Generally, capital and reserves amount to about 5% of a bank's total assets. It is clear that if a default occurs by a major Latin country, many major American banks will become insolvent. *See The Crash of 198?*, ECONOMIST, Oct. 16, 1982, at 23.

25. *Bottomless Debt,* ECONOMIST, Dec. 11, 1982, at 11.

26. *Id.* While many theories of a possible international banking crisis have been advanced, this fear has substance due to various economic realities and interrelationships among countries. Five major factors will weigh considerably in the final dispensation of this problem:

> (1) The falling price of oil makes oil exporting LDC's less able to service their external debt;
> (2) The falling price of oil translates into a less affluent Middle East. With such an event the oil exporting region will need its funds back that it deposited with the Western banks, who in turn advanced funds to the LDC's;
> (3) The banks have a large exposure in their portfolio to LDC's;
> (4) High interest rates make repayment difficult for LDC's. For Mexico and Brazil, each one percent decrease in interest rates saves them an estimated $750 million annually. Although interest rates have decreased, they remain high in real terms;
> (5) Politics: there is a general feeling that Latin America's debt problem will be difficult to shake off. This is a prevailing perception even though real advances have been made by the governments of major debtor countries.

Id.

27. Brief for the New York Clearing House Association as *amicus curiae*, May 21, 1984, Allied Bank International v. Banco Credito Agricola de Cartago, 566 F. Supp. 1440 (S.D.N.Y. 1983). The Clearing House Association consists of twelve commercial banks in New York City. Of these banks, many are among the largest creditors of Central and South American debt. The members of the Association are: The Bank of New York, The Chase Manhattan Bank, N.A., Chemical Bank, Citibank, N.A., Morgan Guaranty Trust Company of New York, Manufacturers Hanover Trust Company, Irving Trust Company, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank U.S.A., and European American Bank & Trust Company. These banks have a vital interest in the outcome of *Allied* because many of the Clearing House Banks are leading participants as managers, agents, and lenders in syndicated commercial loans to foreign sovereigns, their industries, and their private industries. *See The International Debt Threat: A Way to Avoid a Crash, supra* note 4.

(1) Defaults may be encouraged;

(2) Loss of bargaining power on the bank's side in the rescheduling negotiations;

(3) International banking may flee New York City for more favorable jurisdictions where judgments can be obtained as right in the event of a default; and

(4) The possible move of lending to Europe would have a material adverse effect on the economy of New York and the United States, as well as diminish the importance of New York Law as the law of choice in international finance.[28]

The interest at stake for the Clearing House Association is evident as well as the possible repercussions to the American economy.

IV. EXCLUSIVE OF LAW; A CONCERTED METHOD TO ESCAPE AN INTERNATIONAL DEBT CRISIS

If loan defaults could be restricted to smaller debtors such as Costa Rica, the force of the law may very well benefit the lending institutions. Obviously, such a cooperative situation does not exist. The painful truth is that regardless of how American courts finally resolve the situation, the ramifications of a default by major Latin American borrowers simply means a world economic crisis of proportions far beyond any past world depression. While a sovereign immunity defense may prove to exculpate a country from its debts, a default is not likely in the view of banking circles. This is because the deterrents against a country defaulting are too great. The consequences that befell Cuba in 1960 and Ghana briefly in 1962 are a testament to world resolve. Yet, there is the fear that a maverick from the Third World may go where others have feared to tread.[29] Fortunately, bridge financing by the Bank for International Settlements (BIS) has been instrumental in helping debtor countries, such as Mexico in 1982, pass through the rough spots.[30]

28. *Id.* at 4.

29. *The Crash of 198?*, *supra* note 5, at 25. *See generally Re-Scheduling*, ECONOMIST, Feb. 18, 1984, at 81.

30. In an effort to stem country liquidity cries, the BIS in Basel, Switzerland, began to lend to countries outside of Western Europe. The BIS is the central bank for Western European central banks. During the bail-out of Mexico in 1982, the BIS arranged a $1.85 billion short-term line of credit of which 50% came from America's Federal Reserve Bank.

The magnitude of the problem is reflected in the situation that Brazil precipitated in December, 1982. Brazil "unilaterally" declared its inability to service its debt. The banks had no choice but to concede to Brazil's requests, otherwise an economic crisis would have ensued. The Brazilian actions gave a shocking and new perspective to the whole problem of outstanding world indebtedness. Bank loans became frozen assets.[31] The lesson derived from this scenario is that when lenders are involved with a borrower to the point where their own solvency is at issue, it is the borrower that dictates and the lender that follows.[32]

It is inevitable that western governments will have to become involved in solving Latin America's financial troubles. It does not appear that the LDC's have the experience to solve the problem on their own. The lending institutions will eventually have to face up to a massive write-off against their assets and reserves. The short-term solution has been to follow the IMF's lead in buying time and anticipating a surge in world trade that will raise commodity prices. The increased export earnings may then be applied to easily service their debts. However, such short-term remedies do not offer a solution to the problem.

A. *SOLUTIONS TO THE DEBT CRISIS*

Proposals have been offered in the banking community and official circles to develop a facility of funds to aid national governments that cannot meet their obligations.[33] The fundamental problem with increased reliance on temporary stabilization by IMF or World Bank loans is that the temporary nature of the aid is not a solution to the ailment. IMF loans require strict domestic austerity that reduces external dependency.[34] This would lead to a greater

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The Mexican loan was offered in installments conditioned on continual progress in IMF talks. This is the bridge financing that is necessary to keep countries solvent until long-term financing through the IMF can become effective. This action by the BIS signaled strong involvement by an official body to avert a banking collapse. The BIS is a "semi-political" organization that will have to develop a dialogue with major lending institutions if progress in this arena is to continue. *See generally The Crash of 198?, supra* note 5, at 23.

31. *The International Debt Threat: A Way to Avoid a Crash, supra* note 4, at 13.

32. *Id.*

33. J. DEAN & I. GIDDY, AVERTING INTERNATIONAL BANKING CRISES 37 (1981). This to a certain extent has been undertaken by the World Bank and the IMF. The reduction of one source of global risk leads to a certain confidence that can help stem a bank failure. *Id.*

34. *Id.* at 37. Without the strict IMF standards, Dean and Giddy argue that adverse effects may result. If credit was extended to governments at below market rates, there

dependence by the entire banking system on the IMF whose guarantee invoked more frequently would lead to the ultimate providers of funds; the taxpayers of the industrial countries.[35]

Additionally, an international deposit insurance corporation (IDIC) has been suggested as a multinational, non-profit insurer backed by major governments.[36] Such an entity would likely raise confidence in international banking, but it also presents potential problems. A great deal of regulatory authority would have to be vested in the IDIC.[37] Among the powers invested in an IDIC, would be examinatory powers and the power to constrain the domestic and international activities of commercial banks.[38] "Such a transfer [of power] carries connotations both of a substantial loss of domestic regulatory autonomy, and of a supranational regulatory monolith."[39] The flaw with such an international organization is that its authority far exceeds its limited resources and power.[40] Therefore, without the creation of a world central bank,[41] an IDIC is of little value.

The argument has been advanced that even though competition is desirable in international banking, the "new market environment" demands a new regulatory structure.[42] The search for a uniform system applicable to financial institutions might be found in a "supranational lender-of-last resort facility . . . supported by at minimum the Group of Ten central banks."[43] The expectation is that such a well-supported facility would serve to enhance con-

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is a built-in incentive to borrow more than one otherwise would and to invest in projects with lower yields and/or higher risk than those normally accepted. Secondly, because IMF loans are, in effect, guarantees against country risk, banks would not need to analyze country risk and would, therefore, lend more capital than they otherwise normally would to higher risk countries or unproductive projects. *Id.* For an account of the political and social effects of "austerity," *see* N.Y. Times, May 2, 1984, at D2, col. 1.

35. AVERTING INTERNATIONAL BANKING CRISES, *supra* note 33, at 39.

36. *Id.*

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.* at 40.

41. The reason that the Federal Deposit Insurance Corporation (FDIC) is effective is due to the underlying knowledge that it is an instrumentality of the U.S. Government and is secured by the money-creating power vested in the Federal Reserve Bank. *Id.*

42. *Id.* at 41.

43. *Id.* at 41 (quoting EDWARDS, FINANCIAL INSTITUTIONS AND REGULATIONS IN THE 21ST CENTURY: AFTER THE CRASH 19 (1980)). The Group of Ten is composed of prosperous countries who fix and regulate their policies in international monetary activities. It is composed of Belgium, Britain, Canada, France, Italy, Japan, the Netherlands, Sweden, the United States, and West Germany. Switzerland is an unofficial member.

fidence in international banking.[44] "One must conclude that until the world is ready for a global central bank with centralized monetary policy and economic power any proposal for a supranational lender of last resort cannot be taken seriously."[45]

These solutions attempt to approach a method of returning confidence for both domestic and international banks. Unfortunately, the financing needs of the LDC's may not be met in the 1980's, thus creating a deflationary bias to the world economy.[46] But, with the current exposure of lending institutions the ability to raise additional capital will be impaired.[47] The involvement of additional banking institutions, the by-passing of banks and financial intermediaries altogether, and the shift or financing to official agencies has been advocated.[48] Of these three solutions to the immediate problem, the shifting of financing away from the private sector to the IMF, the World Bank, and governments has considerable support. The threat of stagnation raises serious social and political consequences in many of the LDC's. In an effort to bind together the debt problem, the IMF may have to play a pivotal role.[49] Such a role, however, cannot be played out if the IMF is cut off from adequate financial resources and the necessary political support.[50]

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44. *Id.* It is likely that such a facility would fall prey to the same problems as an IDIC discussed earlier. The problem of giving the supranational body authority is that it would undermine central banks' monetary control. But, without such power, the banking public would be unable to rely on this body and would be forced to look to the individual central banks. The question of where the supranational bank would get its money is relevant as well as the question of whether or not the supranational lender of last resort would support banks from non-participating countries. The peril of creating such a body is that it could easily become nothing but a bureaucratic coordinating agency. *Id.*

45. *Id.* at 41-42.

46. Llewellyn, *Avoiding an International Banking Crisis,* NAT'L. WESTMINSTER BANK Q. REV. 28, 29 (Aug. 1982). There is a "potential capital constraint" in countries whose banks have gone through an increase in their external capital assets forcing capital ratios to deteriorate considerably. *See also* United States Brief, *supra* note 11, at 1.

47. *Id.* at 35.

48. *Id.* at 36. While the American banks have the greatest exposure to LDC's, there are many banks that are unable to increase their stake in the LDC's. As the American banks declined from over a 50% exposure in 1975 to less than 40% in 1980, the Japanese and European banks increased their exposures. Since 1979, OPEC institutions have also become a factor. Yet, one would be hard pressed to believe that the exposure levels of the American banks will ever be reached by the European and the Japanese institutions. *Id.*

49. Solomon, *Congress Should Act Quickly on IMF Funding,* AMERICAN BANKER, Sept. 26, 1983, at 4, col. 1.

50. *Id.* Solomon argues that without the IMF at the helm, the consequences are grave. For example, debtor countries would be forced to include more protectionist measures and credit controls that would lead to price distortions and damage to the private sector. For a discussion on world economy and the effect of protectionist measures, *see* Tumlir, *The World*

The IMF's rescue schemes have managed to buy time for the banking community to plan their next move. The need for a long-term solution is paramount to avoid the specter of insolvency of both banks and countries.[51] The ultimate impact of an IMF plan could lead to the taxpayers of the industrialized countries, in effect, bailing out the banks when the debtor countries fail to pay their obligations. This would likely cause a political storm that politicians would prefer to avoid. Governments fear both a run on banks and the political odium of a taxpayer's bail-out.[52] There are other proposed solutions that may be more workable.

The conversion of debtor countries' short-term debt into long-term debt utilizing bonds that carry a lower and fixed rate of interest[53] might be a better solution than involving the IMF. An approach that is classic in the corporate arena is to convert debt into equity.[54] Both of these arrangements may be workable and speculation exists as to the possibility of a market developing to absorb either the newly issued debt or equity. If the creditors were willing to sell their investments at an appropriate discount, it is likely that the open-market would invest in the debtor countries' obligations.

The aforementioned solutions recognize that there is too much existing debt bunched in short-term maturities with high floating interest rates. Unfortunately, they do not address the necessity of

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Economy Today: Crisis or a New Beginning?, NAT'L WESTMINSTER BANK Q. REV., Aug. 1983, at 26.

51. It has long been advanced that after the consent of lenders, the IMF should propose long-term rescheduling of the debt. This should take into consideration not only the immediate cash requirements of a country, but also a projection of earnings and expenditures over a long period of time, for example thirteen years. At that point, the IMF could step in and guarantee the last two years of payments (years 12 and 13). This would show that the IMF is behind the country. Such a rescheduling would give a debtor a realistic time for the world economy to accelerate and for the debtor's economy to develop a surplus to service its debts. If a borrower fell behind on the IMF program, the guarantees would be revoked; this would act as a safeguard against debtors offloading on the IMF guarantee. *The International Debt Threat: A Way to Avoid a Crash, supra* note 4, at 11.

52. ECONOMIST, Feb. 19, 1983, at 85.

53. *Id.* This has been advanced by F. Rohatyn and P. Kenen. The fact that there is too much debt bunched in short-term maturities with high floating interest rates has caused a major impass. The debt could be bought at a 10% discount of book value in exchange for the bonds. If debtors amortized the full face of the debt, then the 10% discount would finance the official conversion. The beauty of such an approach is that the taxpayer is not involved and the banks would carry the loss of a definite amount. *Id.*

54. *Id.* This has been advanced by N. Bailey. Creditors continue to receive interest rate payments, but replace their amortization with a contract that would entitle them to some fixed percentage of a debtor's export earnings during the life of the loan. *Id.*

an official body that is able to install investor confidence in the bond or equity issues. A variation on the Chrysler Corporation Loan Guarantee Act of 1979[55] provides a workable solution to the debt crisis faced by the major banking institutions as well as the world.[56] While the Chrysler Corporation financial problem was not of the scale of the current debt crisis among the Latin and South American countries, the parallels between the two situations are evident.[57]

The countries of the industrialized world, acting through a "debtor country loan board," would guarantee the secured notes of the individual debtor country. Therefore, Brazil, Argentina, and Costa Rica, for example, would issue individual country notes. These notes could be rated according to a country risk rating, priced accordingly, and then matched with those who have an economic interest in the debtor country. The sources for this plan would include concessions or a certain percentage of loan write-offs by the banking syndicates, as well as the issuance of common stock made available to the debtor government's employees and trade creditors.

The secured notes would be distributed through commercial and investment banking operations to investors such as governments, institutions, pension funds, and individuals. This financing scheme would be a bridge during a difficult period. As in the

55. H.R. REP. NO. 96-690, 96th Cong., 1st Sess., *reprinted in* 1979 U.S. CODE CONG. & AD. NEWS 2787.

56. A description of the notes is contained in the offering circular dated February 27, 1981. The head underwriters in the deal were Salomon Brothers, Merrill Lynch White Weld Capital Markets Group, The First Boston Corporation, E.F. Hutton & Company, Inc., and Warburg Paribus Becker. The offering circular is entitled $400,000,000, 14.9% Secured Notes due October 15, 1990, fully guaranteed as to principal and interest by the United States of America, acting through the Chrysler Corporation Loan Guarantee Board, issued by the Chrysler Corporation. A copy of the offering circular is available through the Syracuse University College of Law Library.

57. The Chrysler Corporation is the third largest car and truck manufacturer in the United States and the nation's tenth largest corporation. Subsequent to exhaustive hearings, the United States Government recognized the need for Federal financial assistance in the form of loan guarantees. The need for assistance was predicated on the belief that a default by Chrysler would have "substantial consequences for the nation's economy, the Federal budget, the balance of payments and, above all, several hundred thousand individual human beings." *See* H.R. REP. NO. 96-690, 96th Cong., 1st Sess., *reprinted in* 1979 U.S. CODE CONG. & AD. NEWS 2789. The government assisted to the extent of up to $1.5 billion in Federal loan guarantees that would be matched equally by others who had an economic stake in Chrysler, as required by legislation. The sources of the $1.5 billion "matching" funds were parties with an existing financial stake in Chrysler's health who gave financing commitments or concessions, capital obtained through merger or sale of securities, proceeds from asset dispositions, and the issuance of $100 million of common stock made available to Chrysler's employees and employee representative groups. *See* H.R. REP. NO. 96-690, at 2789.

Chrysler case, this would not be a permanent crutch.[58] The implementation of such a financial plan would aid in the success of the debtor countries' economic future as well as provide an investment vehicle for appropriate investors.

V. CONCLUSION

The critical truth is that the international debt crisis is greater than the law that seeks to enforce such legal obligations. This involves not the misjudgments of a few financial institutions, but the entire banking system. The over-commitment by this interlocking system may prove disastrous unless a plan is conceived that can solve the problem rather than act as a stop-gap for the short-term. The continued financial stability of the entire banking system is necessary for growth in the world economy.

The reaction of official bodies such as the IMF, the World Bank, and the BIS are only short-term solutions.[59] The assumption that the LDC's present a mere liquidity problem and not a harbinger of insolvency is false. It is apparent that the lending institutions and the countries involved in the international debt crisis were overly ambitious in their desire for economic expansion and prosperity. While there have been no major defaults, it is obvious that the lending institutions have stretched to unusual lengths to prevent their borrowers from defaulting.

The ultimate solution must embody two key premises: banks must write off a certain portion of the outstanding obligations as bad debt, and the open market will have to absorb a new discounted debt or equity conversion of the outstanding obligations. Proceeding along such a line will spare the taxpayers of the industrialized nations the cost of this financial debacle. While the magnitude of

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58. It is interesting to note that if Chrysler had become bankrupt, the bankruptcies of supplier companies and Chrysler dealers would have ensued. *See* H.R. REP. NO. 96-690, at 2789. While the Chrysler situation is on a smaller scale than the world debt crisis, it does illustrate the vast interconnections between an institution, be it a corporation or a sovereign government, and the lives it has an effect upon in an adverse turn of economic events.

59. At the 1984 Joint Annual IMF-World Bank meeting in Washington, D.C., the Third World debtor countries were advised to "streamline" their economies and to take steps to attract foreign investment in pursuit of solving their financial difficulties. This official pronouncement may lead to an open market solution to the debt crisis. U.S. Treasury Secretary Donald Regan echoed this sentiment when he stated that the U.S. will resume its earlier push to have the World Bank strongly encourage private enterprise and investment capital to serve as a "catalyst" rather than as a channel for developing loans. Wall Street Journal, Sept. 25, 1984, at 33, col. 2.

the debt is huge, after a portion is written off by the banks, a significant amount could be absorbed by private institutions and governments that find that the risk and reward associated with the investment is within their parameters of acceptability. Without such an alternative, the deadweight of the LDC's nonperforming debt will cause a collapse of the world economy beyond any depression that the world economy has yet sustained.

Therefore, on rehearing the *Allied* court has a great responsibility to shape the law that will be a guide for the banking industry in its resolution of the international debt crisis.

Frank Charles Forelle