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CURRENT LEGAL MATTERS AFFECTING CENTRAL BANKS*

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I. INTRODUCTION

In music, a fugue is a composition based on a theme that is stated at the beginning of a piece by one voice, taken up by a second voice or voices, and reappears throughout the piece at various places in one or another of these voices.[1] This Article will examine some current legal developments in central banking in much the same way as a musical fugue operates. Several different developing areas of the law, apparently distinct and unrelated, will be tied together through a common recurring theme. The areas to be examined are: (i) the emerging law of standby letters of credit; (ii) the plea of sovereign immunity as it relates to a central bank; (iii) some implications of certain bank failures and expropriations; and (iv) the application of article VIII section 2(b) of the Articles of Agreement of the International Monetary Fund. The theme that recurs throughout these subjects is the letter of credit.

II. THE EMERGING LAW OF STANDBY LETTERS OF CREDIT

A Brief Retrospective on the Letter of Credit

A letter of credit (or "credit") is an undertaking made by a bank, at the request of a customer, to honor drafts drawn by the beneficiary of the credit in accordance with the conditions speci-

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[1] *See* W. APEL & R. DANIEL, HARVARD BRIEF DICTIONARY OF MUSIC 114 (1960).

fied by it.[3] There are always at least three parties to a letter of credit. The issuer is the bank opening the credit. The customer (or account party) is the person who causes the issuer to open the credit. The beneficiary is the person who is entitled to draw or demand payment under the credit. In some of the examples examined there may also be a second bank located in the country of the beneficiary. This Article will consider two types of credits: the commercial letter of credit and the standby letter of credit.

The Commercial Letter of Credit

Suppose that American Suits Company in Baltimore wants to buy 300 bolts of woolen cloth from British Woolens Company in London. American Suits does not want to send a bank draft with its order without assurance that the cloth has been shipped. British Woolens is not familiar with the creditworthiness of American Suits and does not want to risk nonpayment. In these circumstances, American Suits requests its bank, Baltimore National Bank, to issue a letter of credit in favor of British Woolens. Upon receipt of the credit, British Woolens has the assurance of the credit-extending bank that if it presents the documents called for in the letter of credit it will receive payment. Typically, these documents will include invoices, documents of insurance, and a bill of lading issued by a carrier evidencing the shipment of the cloth and conveying title to the goods in transit. In addition to the three parties already noted, a fourth party might figure in the transaction. If British Woolens desires the added security of a bank's engagement in England, it might require that the credit be confirmed by a London bank. The scene is now set for British Woolens to ship the goods and present the documents required under the credit together with its draft against Baltimore National (or the local bank in London if the credit is a confirmed one). After assuring itself that the documents presented accord with those specified by the credit, the paying bank will charge the appropriate account. If there are but three parties, then Baltimore National would charge the account of its customer, American Suits. If the credit were confirmed, the London bank would charge the account of its correspondent, Baltimore National, and the latter would, in turn, charge

[3] *See* UNIFORM CUSTOMS AND PRACTICE FOR DOCUMENTARY CREDITS, General Provisions and Definitions (b) (I.C.C. Pub. 290, 1974) [hereinafter cited as U.C.P.]; *see also* U.C.C. § 5-103(1)(a) (1978).

the account of American Suits.[3]

The Standby Letter of Credit

A very different set of circumstances invites the use of a standby letter of credit in international financial transactions. Typically, the circumstances involve foreign government procurement and construction programs.

One area in which standby letters of credit have been used with frequency is the Middle East. Suppose that a government agency in Oman awards a procurement contract to Construction Company in New York to install air conditioning equipment in government buildings. As a condition of the contract, the Oman Government requires the New York building contractor to secure a ninety day warranty on the equipment with an amount equivalent to five per cent of the contract price. Rather than setting aside a deposit of actual funds in escrow, Construction Company may decide to request its bank in New York, Manhattan Trust, to issue in favor of the government agency in Oman a standby letter of credit naming the latter as beneficiary. The terms of credit may permit the agency to draw on it solely upon demand and without other explanation. It should be noted that, as in the case of the commercial credit, the standby credit can also be set up with a fourth party. In such a case, the standby letter of credit issued by the New York bank might name a bank in Oman, rather than the agency itself, as beneficiary. Oman Bank might then extend its guaranty to the agency. This arrangement would be activated by a representation made by the agency to Oman Bank and the latter's demand for payment as beneficiary under the standby credit extended in its favor by the Manhattan Trust.[4]

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[3] Documentary credit is defined as:

> any arrangement, however named or described, whereby a bank (the issuing bank), acting at the request and in accordance with the instructions of a customer (the applicant for the credit), (i) is to make payment to or to the order of a third party (the beneficiary), or (ii) authorises such payments to be made or such drafts to be paid, accepted or negotiated by another bank, against stipulated documents, provided that the terms and conditions of the credit are complied with.

U.C.P., *supra* note 2, General Provisions and Definitions (b).

[4] *See* Obligations Subject to Lending Limits, 12 C.F.R. § 7.1160(a) (1983). A standby letter of credit is defined as:

> any letter of credit, or similar arrangement however named or described, which represents an obligation to the beneficiary on the part of the issuer (1) to repay money borrowed by or advanced to or for the account of the account party or (2) to make payment on account of any indebtedness undertaken by the account

Differences Between Commercial and Standby Credits

At this point it is appropriate to consider the differences between the two types of credits. Four main differences may be discerned:

(a) While all parties to the commercial credit expect that the beneficiary will draw upon it in the ordinary course of the transaction, the parties to a standby credit do not expect that the beneficiary will draw under it unless a problem arises between the parties as a consequence of some non-performance.

(b) While commercial credits may be "clean," *i.e.* require no documents, in the transactions considered thus far involving the international transportation of goods, a documentary credit is usually involved. Under such a credit, third party documents such as a bill of lading are required. In contrast, the provisions of a typical standby credit require only a declaration by the beneficiary that the account party has failed to perform.

(c) Assuming the use of a documentary commercial credit and a clean standby credit, an important difference arises in the security available to the opening bank. Under a commercial credit, the documents of title to the shipment of goods (and the goods that they represent) constitute security to the obligation of the bank to make payment. Under a standby credit, however, there is no such security.

(d) While the customs and law that govern the commercial credit have been carefully developed and clarified over the de-

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> party, or (3) to make payment on account of any default by the account party in the performance of an obligation.

Id. See also Comptroller's Interpretative Ruling, 12 C.F.R. §7.7016 (1983), which sets out further guidelines for banks:

> As a matter of sound banking practice, letters of credit should be issued in conformity with the following: (a) each letter of credit should conspicuously state that it is a letter of credit or be conspicuously entitled as such; (b) the bank's undertaking should contain a specified expiration date or be for a definite term; (c) the bank's undertaking should be limited in amount; (d) the bank's obligation to pay should arise only upon the presentation of a draft or other documents as specified in the letter of credit, and the bank must not be called upon to determine questions of fact or law at issue between the account party and the beneficiary; (e) the bank's customer should have an unqualified obligation to reimburse the bank for payments made under the letter of credit.

Id. The growth of standby letters of credit issued by United States bank holding companies has been substantial. "The total amount of standby letters of credit . . . grew 33.7% at the top 10 holding companies during 1981 to $42.1 billion. At yearend, this sum was equal to 7% of the banks' total assets and 181% of their combined shareholders' equity." Norton, *Standby Letters: An Off-Balance-Sheet Boom,* THE AMERICAN BANKER, June 24, 1982, at 1.

cades, no such body of rules and decisions characterizes the practice surrounding the use of the standby credit, a relative newcomer.

It is the last of these differences that is focused upon here. Bankers and courts throughout the world are familiar with the Uniform Customs and Practice for Documentary Credits (U.C.P.), a set of rules developed under the aegis of the International Chamber of Commerce. These rules are almost universally accepted as governing traditional commercial credits. Supplemented by national law, which in some cases expressly defers to them,[5] the rules and the law together form a reliable conceptual framework for the commercial credit based on documents. By contrast, there is no such body of law and practice that gives agreed structure to transactions involving standby credits. Private parties, bankers, and governments are attempting to sketch out these rules.[6] In this aura of newness and development, it is not surprising that despite the substantial differences between the two instruments, courts are turning to the familiar precedents of the commercial credit in order to help resolve the problems posed by the standby credit.

Before examining the key cases in the developing area of the standby credit, *American Bell International, Inc. v. Islamic Republic of Iran*[7] and *Itek Corp. v. First National Bank of Boston*,[8] consider some of the rules that are currently believed to be applicable to both types of credits.[9]

Rules Applicable to Both Commercial and Standby Credits: Separation of Contracts and the Duty of the Bank to Pay

It is generally recognized that both kinds of letters of credit can be broken, for purposes of analysis, into their component arrangements. In the basic case which involves three parties, three separate agreements may be distinguished:

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[5] *See, e.g.*, N.Y.U.C.C. § 5-102(4) (McKinney 1964).

[6] In a proposed revision of the U.C.P., *supra* note 2, it is expressly stated that standby credits are to be governed, where applicable, by the U.C.P. *See* Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ. L. REV. 319, 346 (1982).

[7] 474 F. Supp. 420 (S.D.N.Y. 1979).

[8] 511 F. Supp. 1341 (D. Mass. 1981), *vacated*, 704 F.2d 1 (1983).

[9] It should be noted that the proposed revision of the U.C.P. which would apply to both standby and commercial credits has been criticized. One observer has stated that "standby letters of credit are such a different institution from ordinary documentary credits that I consider it unwise and potentially leading to confusion that the new U.C.P. should extend to this type of financial facility." Schmitthoff, *The New Uniform Customs for Letters of Credit*, J. BUS. L., May 1983, at 193, 195 (1983).

(a) the agreement between the account party (American Suits in the commercial credit example; Construction Company in the standby credit example) and the beneficiary (British Woolens in the commercial credit example; Government Agency in the standby credit example). This is evidenced by the underlying contract of sale.

(b) the agreement between the issuing bank (Baltimore National Bank in the commercial credit example; Manhattan Trust in the standby credit example) and the beneficiary (British Woolens in the commercial credit example; the government agency in the standby credit example). This is the letter of credit.

(c) the agreement between the account party (American Suits in the commercial credit example; Construction Company in the standby credit example) and the issuing bank (Baltimore National Bank in the commercial credit example; Manhattan Trust in the standby credit example). This is ordinarily in the form of an application for a credit.

In accordance with this analysis, each contract is separate from the others. Thus, the letter of credit is independent of the underlying contract between the account party and the beneficiary.[10] It follows that the issuing bank's obligation does not include liability or responsibility for performance of the underlying contract for sale between the account party and the beneficiary.[11]

A bank's duty is limited to inspection of the documents and does not include concern with the goods.[12] According to article 7 of the U.C.P., it must examine all documents with reasonable care to as-

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[10] U.C.C. § 5-114 comment 1 (1978).

[11] U.C.C. § 5-109(1)(a) (1978). The principle is expressed in U.C.C. §5-114(1) (1978):

> An issuer must honor a draft or demand for payment which complies with the terms of the relevant credit regardless of whether the goods or documents conform to the underlying contract for sale or other contract between the customer and the beneficiary.

Id. Articles 9, 10, and 11 of the U.C.P., *supra* note 2, clarify that a bank opening a letter of credit assumes no liability for a host of items that may go wrong. Thus article 9 provides:

> Banks assume no liability or responsibility for the form, sufficiency, accuracy, genuineness, falsification or legal effect of any documents, or for the general and/or particular conditions stipulated in the documents or superimposed thereon; nor do they assume any liability or responsibility for the description, quantity, weight, quality, condition, packing, delivery, value or existence of the goods represented thereby, or for the good faith or acts and/or omission, solvency, performance or standing of the consignor, the carriers or the insurers of the goods or any other person whomsoever.

Id.

[12] U.C.P., *supra* note 2, art. 9.

certain that on their face they appear to be in accord with the terms of the credit.[13] If they appear on their face to be inconsistent with one another, they will be considered as not appearing on their face to be in accordance with the terms of the credit.[14] They should conform precisely. A more difficult question is posed by documents which appear on their face to comply but which, in fact, are forged, fraudulent, or part of a transaction involving fraud.

Exception to the Bank's Duty to Pay Under a Commercial Credit: Claim of Fraud

This issue was posed in the landmark case of *Sztejn v. J. Henry Schroder Banking Corporation.*[15] In *Sztejn*, the plaintiff had contracted to buy a quantity of bristles from Transea Traders in Lucknow, India and had caused its bank, J. Henry Schroder Banking Corporation, to issue an irrevocable commercial letter of credit in favor of the sellers. Transea had then placed fifty cases on board a ship and procured both a bill of lading from the steamship company and the customary invoices describing the bristles called for by the letter of credit. Transea then drew a draft under the letter of credit and presented it for collection, together with the documents called for by the credit, to the defendant bank in India. The complaint alleged that, instead of shipping bristles, Transea had filled the cases with cowhair and rubbish with intent to simulate genuine merchandise in order to defraud the plaintiff and that the documents presented with the draft for payment were accordingly fraudulent.[16]

In granting the plaintiff's request for an injunction to restrain the presentment to and payment by the defendant issuing bank of the drafts, the Supreme Court, Special Term, New York County, gave heed to the principle of the independence of contracts and to its corollary that in undertaking an obligation to honor a draft drawn in accordance with the terms of a commercial letter of credit, a bank deals in documents, not goods.[17]

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[13] *See also* U.C.C. § 5-109(2) (1978).

[14] U.C.P., *supra* note 2, art. 7.

[15] 31 N.Y.S.2d 631 (1941).

[16] *Id.* at 633.

[17] The court stated that:

> [i]t is well established that a letter of credit is independent of the primary contract of sale between the buyer and the seller. The issuing bank agrees to pay upon presentation of documents, not goods. This rule is necessary to preserve the

However, the court qualified these principles in a situation in which there was intentional fraud. The court held that where the seller intentionally fails to ship the goods purchased by the buyer and this failure is brought to the attention of the bank before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation should not be allowed to protect the actions of a fraudulent seller.[18]

The decision of the court was codified in section 5-114 of the Uniform Commercial Code (U.C.C.).[19] The significance and authority of the case have carried forward from the well-established field of commercial credits to the developing field of standby credits.

> efficiency of the letter of credit as an instrument for the financing of trade. One of the chief purposes of the letter of credit is to furnish the seller with a ready means of obtaining prompt payment for his merchandise. It would be a most unfortunate interference with business transactions if a bank before honoring drafts drawn upon it was obliged or even allowed to go behind the documents, at the request of the buyer and enter into controversies between the buyer and the seller regarding the quality of merchandise shipped. . . .

Id.

[18] The court stated that:

> [t]his is not a controversy between the buyer and seller concerning a mere breach of warranty regarding the quality of the merchandise; on the present motion, it must be assumed that the seller has intentionally failed to ship any goods ordered by the buyer. In such a situation, where the seller's fraud has been called to the bank's attention before the drafts and documents have been presented for payment, the principle of the independence of the bank's obligation under the letter of credit should not be extended to protect the unscrupulous seller.

Id. at 634. The court went on to quote with approval another case stating that "when the issuer of a letter of credit knows that a document, although correct in form, is, in point of fact, false or illegal, he cannot be called upon to recognize such a document as complying with the terms of a letter of credit." *Id.* at 635.

[19] U.C.C. § 5-114(2) (1978) provides:

> Unless otherwise agreed when documents appear on their face to comply with the terms of a credit but a required document does not in fact conform to the warranties made on negotiation or transfer of a document of title (Section 7-507) or of a certificated security (Section 8-306) or is forged or fraudulent or there is fraud in the transaction:
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> (a) the issuer must honor the draft or demand for payment if honor is demanded by a negotiating bank or other holder of the draft or demand which has taken the draft or demand under the credit and under circumstances which would make it a holder in due course (Section 3-302) and in an appropriate case would make it a person to whom a document of title has been duly negotiatied (Section 7-502) or a bona fide purchaser of a certificated security (Section 8-302); and
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> (b) in all other cases as against its customer, an issuer acting in good faith may honor the draft or demand for payment despite notification from the customer of fraud, forgery or other defect not apparent on the face of the documents but a court of appropriate jurisdiction may enjoin such honor.

Exception to the Bank's Duty to Pay Under a Standby Credit: Claim of Fraud

The change of governments in Iran following the revolution in that country in 1978 and 1979 posed a severe challenge to the integrity of the standby letter of credit in international trade. The relatively new instrument had acquired widespread acceptance and was being used with frequency in trade with the Middle East. These credits involved many millions of dollars. It was standard practice for United States contracting concerns to cause their banks to open irrevocable standby letters of credit incident to their performance of the contracts with Iranian government agencies. Following the Iranian revolution, with the status of the underlying contracts in doubt, many of the United States contractors sought to enjoin the issuing banks from honoring demands for payment under the standby credits on the ground of fraud. The issuing banks resisted, arguing that such a development would jeopardize the utility of the new instrument and cast doubt on the reliability of United States financial arrangements in international trade. The first case to come to adjudication was *American Bell International, Inc. v. Islamic Republic of Iran.*[20]

In *American Bell*, the plaintiff, Bell, had entered into a contract with the Ministry of War of the Imperial Government of Iran to provide consulting services and equipment for its communications system. The Imperial Government paid Bell a downpayment on the purchase price but required Bell to obtain from an Iranian bank, Bank Iranshahr, an unconditional and irrevocable guaranty in favor of the Imperial Government. In turn, Bank Iranshahr required Bell to obtain a standby letter of credit from its bank, Manufacturers Hanover Trust, in favor of Bank Iranshahr in the amount of the downpayment. The purpose of this standby credit was to secure reimbursement to Bank Iranshahr in the event that it was required to pay the Imperial Government under its guaranty. Bell commenced work under the contract, but in the wake of the revolution, with unpaid invoices and claims, ceased performance in early 1979. When Manufacturers Hanover Trust notified Bell that it had received a conforming demand under the standby credit to make payment to Bank Iranshahr, Bell sought a preliminary injunction to restrain the making of such payment.[21]

[20] 474 F. Supp. 420 (S.D.N.Y. 1979).

[21] *Id.* at 422.

The United States district court denied the motion for a preliminary injunction. It found that the plaintiff had failed to meet the criteria required before a preliminary injunction may be granted.[22] The court held that Bell had failed to show that there were sufficiently serious questions going to the merits and a balance of hardships that would tip decisively in the plaintiff's favor if the case were litigated. Bell would lose the amount of the downpayment upon the honoring by Manufacturers Hanover Trust of the draft drawn under the standby; however, the court reasoned that if Manufacturers Hanover Trust refused to pay, Bank Iranshahr could sue on the letter of credit and attach the former's assets in Iran. Moreover, such refusal would lead to substantial adverse consequences in the international banking community since Manufacturers Hanover Trust would face a loss of credibility from its failure to make good on a letter of credit.[23]

The court also ruled that Bell failed to demonstrate that litigation, if pursued, would result in probable success on the merits in its favor. In order to achieve such success, Bell would have to show either that a demand for payment conforming to the letter of credit had not been made or that even if a demand had been made, it should not be honored because of fraud in the transaction. The court found it less than probable that nonconformity with the terms of the credit could be proved.[24]

Bell did not contend that any of the documents were fraudulent as a result of misstatements or omissions. It argued that there was "fraud in the transaction."[25] This, Bell claimed, derived from the totality of the circumstances. The court, however, found no real evidence of fraud since Iran had the right to repudiate the contract and pay damages.[26]

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[22] *Id.* at 426.

[23] *Id.*

[24] *Id.* at 423. The court went on to note that:

> [i]f conformity is established, as here, the issuer of an irrevocable, unconditional letter of credit, such as Manufacturers, normally has an absolute duty to transfer the requisite funds. This duty is wholly independent of the underlying contractual relationship that gives rise to the letter of credit. *Shanghai Commercial Bank, Ltd. v. Bank of Boston Int'l*, 53 A.D.2d 830, 385 N.Y.S.2d 548 (1st dep't 1976). Nevertheless, both the Uniform Commercial Code of New York, which the parties concede governs here, and the courts state that payment is enjoinable where a germane document is forged or fraudulent or there is fraud in the transaction.

474 F. Supp. at 424.

[25] *Id.*

[26] *Id.* at 425. The court stated that:

> [a]bsent any showing that Iran would refuse to pay damages upon a contract ac-

Finally, the court found that the plaintiff had failed to show that, absent the grant of the injunction, it would suffer irreparable injury. While the evidence warranted a conclusion that resort by Bell to the Iranian courts would not likely meet with success, Bell had not demonstrated that it was without appropriate remedy under the United States Foreign Sovereign Immunities Act.[27]

As the relations between Iran and the United States deteriorated, the view of both the United States Government and United States courts changed. Following the taking of hostages in the United States Embassy in Teheran in November 1979, President Carter issued Executive Order No. 12170. This executive order, issued under the provisions of the International Emergency Economic Powers Act, blocked all property and interest therein of the Government of Iran and authorized the Secretary of the Treasury to implement the blocking order.[28] The Secretary, in turn, issued what became known as the Iranian Assets Control Regulations, which prohibited the unauthorized transfer of property in which Iran had an interest.[29] This included transfers in connection with standby letters of credit. While these Regulations barred the entry of any final judgment that affected blocked assets, they did not bar certain other judicial proceedings. Furthermore, they authorized a procedure to forestall the payment of standby credits for which requests were received from Iranian beneficiaries. Pursuant to this procedure, a bank that received a demand for payment from an Iranian beneficiary was required to notify the account party. The latter might then apply for a specific license from the Treasury to open a blocked account on its books in the name of the Iranian beneficiary. This procedure could thus avoid the payment by the bank into a blocked account of its own with consequential reim-

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> tion here or in Iran, much less a showing that Bell has even attempted to obtain such a remedy, the evidence is ambivalent as to whether the purported repudiation results from non-fraudulent economic calculation or from fraudulent intent to mulct Bell.

Id.

[27] *See* Foreign Sovereign Immunities Act, 28 U.S.C. § 1330 (1976). *See generally* Getz, *Enjoining the International Standby Letter of Credit: The Iranian Letter of Credit Cases*, 21 HARV. INT'L L.J. 189 (1980); Driscoll, *The Role of Standby Letters of Credit in International Commerce: Reflections After Iran*, 20 VA. J. INT'L L. 458 (1980); Harfield, *Enjoining Letter of Credit Transactions*, 95 BANKING L.J. 596 (1978); Weisz and Blackman, *Standby Letters of Credit After Iran: Remedies of the Account Party*, U. ILL. L. REV. 355 (1982).

[28] 50 U.S.C. § 1701 (Supp. V 1981).

[29] Iranian Assets Control Regulations, 31 C.F.R. § 535.568 (1982).

bursement by the account party.[30]

Amid the changing political environment and the issuance of the Iranian Assets Control Regulations, *Itek Corp. v. First National Bank of Boston* was litigated.[31] The case arose out of demands made on three standby credits issued for Itek by First National Bank in favor of Bank Melli in Iran, the beneficiary.

Itek had contracted with the Imperial Government of Iran in 1977 to manufacture special optical equipment for the contract price of $22,500,000. The contract obligated Itek to furnish bank guarantees issued by an Iranian bank to the Imperial Government. Itek obtained these from Bank Melli. In turn, Bank Melli required Itek to procure in its favor letters of credit issued by Itek's United States bank, First National Bank. Work proceeded in 1979, and in April of that year, the United States Department of State cancelled Itek's export license.[32]

The underlying contract stated that in case of *force majeure* the contract could be cancelled and the bank guarantees would be released. Cancellation of Itek's export license was one of the occurrences listed in the contract that could give rise to the declaration of *force majeure*. When the United States Department of State cancelled its export license, Itek had performed almost $20,000,000 of the work contemplated under the contract, but had received payment of only $11,000,000. Under these circumstances, in accordance with the contract, Itek first attempted to settle accounts with the Iranian Ministry of War and then followed contractual procedures leading to cancellation of the contract for *force majeure*, as well as to the release of the bank guarantees.[33]

Itek also obtained a temporary restraining order from the court preventing First National Bank from honoring any demand for payment on the credits issued in favor of Bank Melli without giving Itek at least three days notice. Thereafter, Bank Melli sent First National Bank two telexes requesting extension of the outstanding letters of credit or, alternatively, immediate payment under them. The court entered a temporary restraining order, and Itek subsequently sought and obtained a preliminary injunction which enjoined payment by First National Bank under the

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[30] *See id.*

[31] 511 F. Supp. 1341 (D. Mass. 1981), *affirmed and modified* in Civil Action No. 80-58-MA, slip op. (May 25, 1982), *vacated*, 704 F.2d 1 (1st Cir. 1983).

[32] 511 F. Supp. at 1342-43.

[33] *Id.* at 1343-44.

credits.[34]

Itek's success ended when it sought to convert the preliminary injunction into a permanent injunction against payment under the standby credits and to obtain a final judgment in the case. In support of these goals, Itek charged that Bank Melli's demand for payment under the letters of credit did not conform to their terms and that there was fraud in the transaction within the meaning of section 5-114 of the U.C.C.[35]

The district court found in favor of Itek that Bank Melli's telexed demands for payment were nonconforming in that they failed to certify the amount that First National Bank had to pay to the Ministry of War and thereby omitted an essential term. The district court stated that in these circumstances it was being asked to allow First National "to honor a draft on a letter of credit on the basis of a foreign bank's overbroad statements of its liabilities to a beneficiary where both beneficiary and bank are controlled by a single government."[36] Moreover, the court found that the letters of credit had expired before a required signed statement from Bank Melli had arrived.[37]

The district court also found in favor of Itek on the ground that there was fraud in the transaction. In the view of the court there existed a clear case of fraud under U.C.C. § 5-114(2)(b), which authorizes a court of "appropriate jurisdiction" to enjoin honoring a letter of credit where there existed fraud in the transaction. The district court found that the Bank Melli's refusal to credit Itek's account with the amount owed and its attempt to recover an additional sum of $3,5000,000 constituted fraud.[38]

In accordance with its findings, the district court entered summary judgment against First National Bank and Bank Melli and issued a permanent injunction enjoining the former from honoring any demand for payment under the letters of credit.[39] The permanence of this injunction, however, was soon called into question.

On January 19, 1981, the United States and Iran had reached agreement on the release of the Americans that had been taken hostage in Teheran. In accordance with this agreement, the United

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[34] *Id.* at 1344.

[35] Itek Corp. v. First Nat'l Bank of Boston, Civil Action No. 80-58-MA, slip op. at 1 (1982).

[36] *Id.* at 4.

[37] *Id.* at 4-5.

[38] *Id.* at 5-6.

[39] *Id.* at 6-7.

States agreed to return to Iran financial assets that had been blocked and to submit claims of United States and Iranian nationals against each others' governments to an International Arbitral Tribunal. The United States also agreed to terminate litigation in United States courts concerning claims that were subject to arbitration in accordance with the agreement.[40]

Whatever the status of other claims under the agreement, all was not settled with respect to standby letters of credit. This became clear as the stage was reached for implementation. While a new executive order[41] was issued by President Reagan which suspended in United States courts "[a]ll claims which may be presented to the Iran—United States Claim Tribunal," the order expressly exempted "any claims concerning the validity or payment of a standby letter of credit."[42] This exemption was also reflected in amendments to the Iranian Assets Control Regulations issued by the Secretary of the Treasury.[43] At the same time these amendments removed the bar against final judgments in such cases.[44]

Under these circumstances the district court handed down its final judgment and permanent injunction in the *Itek* case.[45] Before a month had elapsed following the entry of judgment in *Itek*, however, the Treasury Department amended the Regulations on July 2, 1982 to clarify that the relevant provision does not authorize any final judgment which seeks to permanently enjoin, terminate, or otherwise dispose of any Iranian interest in any standby letter of credit or similar obligation.[46]

Moreover, the United States Government filed a Statement of Interest with the district court in which it sought to persuade the court that this amendment should apply to judgments handed down before it was issued if such judgments were not final in the

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[40] *See* U.S. Authorization to Approve Text of Documents relating to the Release of the Hostages, Jan. 18, 1981, 20 I.L.M. 223.

[41] Exec. Order No. 12,294, 14 Fed. Reg. 14,111 (1981), *reprinted in* 50 U.S.C. § 1701 app. at 872 (Supp. 1982).

[42] *Id.*

[43] Iranian Assets Control Regulations, 31 C.F.R. § 535.222 (1982).

[44] *See id.* §§ 535.504, 535.508.

[45] Itek Corp. v. First Nat'l Bank of Boston, Civil Action No. 80-58-MA, slip op. at 6-7.

[46] The amended regulation states that it does not authorize "any final judicial judgment or order (A) permanently enjoining, (B) terminating or nullifying, or (C) otherwise permanently disposing of any interest of Iran in any standby letter of credit, performance bond or similar obligation. Any license authorizing such action is hereby revoked and withdrawn." Amendments to Iranian Assets Regulations, 47 Fed. Reg. 29,528 (1981) (to be codified at 31 C.F.R. § 535.504 (b)(3)(i)).

sense that they were still subject to appeal. To bolster this position, the Treasury Department once again amended the Regulations to incorporate this view into the relevant provision.[47]

By way of explanation, the Treasury Department stated that while the Regulations are intended to permit United States account parties to obtain preliminary injunctions or other temporary relief against payment under standby credits, "any judgment or court order which finally extinguishes Iran's interest in a standby letter of credit or similar obligation is prohibited, including any such judgment or order which was entered prior to July 2, 1982, but which was subject to appellate proceedings as of that date, such as the judgment in the case of *Itek v. First National Bank of Boston.*"[48]

Armed with the amended Regulation, First National Bank and Bank Melli appealed from the district court decision. In light of the amended provisions, the appellants sought to vacate the judgment which purported to be final and the order for a permanent injunction. Itek countered by contesting, among other things, the validity of the amendments to the Regulation. The United States Court of Appeals for the First Circuit agreed with the position advocated by the appellants (and the United States Government).[49] In the course of its decision, the court held that while the judgment below was rightfully rendered, the subsequent Regulations had made the decision no longer appropriate. The court further refused to address the lower court's finding of the existence of fraud and left the district court free to impose other permissible relief, such as a preliminary injunction.[50]

Thus the matter rests, at least for the present. While the United

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[47] The amended regulation states:

(b) This section does not authorize:

(3)(i) Any final judicial judgment or order (A) permanently enjoining, (B) terminating or nulifying, or (C) otherwise permanently disposing of any interest of Iran in any standby letter of credit, performance bond or similar obligation. Any license authorizing such action is hereby revoked and withdrawn. This revocation and withdrawal of licenses prohibits judgments or orders that are within the terms of this subparagraph (3)(i), including any such judgments or orders which may have been previously entered but which had not become final by July 2, 1982, through the conclusion of appellate proceedings or the expiration of the time for appeal.

Amendments to Iranian Assets Control Regulations, 47 Fed. Reg. 55,481 (1982) (to be codified at 31 C.F.R. § 535.504 (b)(3)(i)).

[48] *Id.*

[49] Itek v. First Nat'l Bank of Boston, 511 F.2d 1 (1st Cir. 1983).

[50] *Id.* at 11.

States maintains its position that the agreement with Iran does not require arbitration before the Claims Tribunal of controversies that arise out of standby credits, it has instituted a temporary bar to final judgments in its courts pending the settlement of this question.[51]

Where does this leave the question of whether fraud sufficient to support an injunction against payment under a standby credit can derive from political controversy? Is a demand for payment under a standby credit, if made primarily for political rather than economic reasons, a form of fraud in the transaction?[52] When the initial clarity of *American Bell* is compared with the inconclusiveness of the *Itek* litigation, one must conclude that the criteria are still unsettled for testing fraud in the context of standby credits. The bare recital of the facts by the district court in *Itek* (which on this point appear not to differ appreciably from those in *American Bell*) does little to advance matters.[53] The court of appeals studiously avoided expressing an opinion on the substantive questions, applying to the case only the provisions of the amended Regulation.[54] In this light there is ground for reflection on the reservation that the United States has entered. The effect of this reservation would preserve the resolution of controversies concerning standby credits to the national courts and remove these controversies (with the inevitable issue of politically motivated fraud) from the consideration of the Claims Tribunal.

Why, of all claims, should standby letters of credit possibly be exempt from the provisions of an international agreement? It has been suggested that, on the one hand, the United States Government is attempting to balance its right to regulate matters within its own jurisdiction while simultaneously protecting its treaty obli-

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[51] The United States Treasury Department noted when extending the time period of this bar that:

> Iran has filed with the Iran-United States Claims Tribunal 229 claims based on standby letters of credit or similar bank instruments. On December 1, 1982, the United States filed with the Tribunal a request that the Tribunal determine which, if any, of these claims come within the Tribunal's jurisdiction. On October 25, 1982, Iran filed with the Tribunal an allegation that the United States has violated its obligations under the Algiers Accords by failing to transfer to Iran the amounts of these standby letters of credit. The Tribunal may rule both on the United States jurisdictional request and on the Iranian allegation as to United States obligations under the Accords within the next year.

47 Fed. Reg. at 55,482.

[52] *See* Driscoll, *supra* note 27, at 484.

[53] *See supra* notes 31-39 and accompanying text.

[54] *See supra* notes 45-48 and accompanying text.

gations which call for settlement of claims between Iran and the United States. On the other hand, it is noted that the United States Government does not wish to impede the ability of its nationals to prosecute and defend claims involving standby credits which are often contradictory.[55] In this area United States citizens are arranged on both sides of complex factual patterns and legal relationships, often, as in *American Bell* and *Itek*, in the very same cases.

III. THE PLEA OF SOVEREIGN IMMUNITY AS IT RELATES TO A CENTRAL BANK

Two Doctrines of Sovereign Immunity: Absolute and Restrictive

The international law concept of sovereign immunity gradually has undergone a fundamental shift. This shift has been from the classical doctrine of absolute immunity to a more restrictive theory. Traditionally, foreign sovereigns enjoyed an absolute immunity from both suit and execution on their assets: the sovereign could not be made a respondent in the courts of another sovereign without his own consent. This absolute immunity derived from the unqualified independence of every sovereign authority and from the demands of international comity which require every sovereign state to respect the dignity and independence of every other state.[56] The doctrine seemed fixed and unyielding in an era in which sovereign states declined to engage in commercial activities.

Over the last seven decades, however, the nearly universal perception of the role of the sovereign state has changed. Almost every state now engages in commercial activities in some form or another, whether through direct action of a government department or through the creation of separate legal entities. Consequently, the absolute doctrine of sovereign immunity first suffered attack and then almost everywhere expired. The notion that private persons engaged in commerce with the sovereign would be without a mode of effective redress should controversy develop between the parties concerning their respective obligations was basic to the criticism. In the wake of an increasing number of such encounters, scholars, judges, and the public became convinced that if inroads were not made on the doctrine, its unrestricted availability

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[55] *See* Silverman and Ulmer, *The Iranian Letter of Credit Cases: An International Imbroglio*, 15 MIDDLE E. EXECUTIVE REP. 196 (Nov. 1982).

[56] *See* The Parlement Belge, [1880] 5 P.D. 197, 214-15.

would permit a government to switch back and forth from the role of a trader to that of a sovereign depending upon which role best served its interest at the moment.[57]

Under the impetus of perceived inequity in the application of the absolute doctrine, acceptance of the newer restrictive theory of sovereign immunity grew rapidly. According to this theory, sovereign immunity is still recognized when the state is involved in public acts (*jure imperii*) but is no longer recognized in regard to private acts (*jure gestionis*).[58] Thus, if in the words of Lord Denning, a dispute were to bring into question:

> the legislative or international transactions of a foreign government, or the policy of its executive, the court should grant immunity if asked to do so, because it does offend the dignity of a foreign sovereign to have the merits of such a dispute canvassed in the domestic courts of another country; but if the dispute concerns, for instance, the commercial transactions of a foreign government (whether carried on by its own departments or agencies or by setting up separate entities), and it arises properly within the territorial jurisdiction of our courts, there is no ground for granting immunity.[59]

Twenty years after this statement, which formed part of a call for review of the theory of sovereign immunity so as to bring English law into accord with that of the majority of states that had by this time firmly established themselves within the camp of the restrictive theory, a case arose before Lord Denning which would prove to be the last great contest between the two theories.

The Last Great Battle Between the Two Theories of Sovereign Immunity

Trendtex Trading Corp., Ltd. v. Central Bank of Nigeria arose from extraordinary circumstances involving one of the most enormous commercial disputes in history.[60] The Nigerian Government,

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[57] The unrestricted availability of sovereign immunity would in the words of one judge:

> authorize a sovereign prince to assume the character of a trader, when it is for his benefit; and when he incurs an obligation to a private subject to throw off . . . his disguise, and appear as a sovereign, claiming for his own benefit, and to the injury of a private person, for the first time, all the attributes of his character.

The Charkiel, [1873] 4 L.R.-Adm. & Eccl. 59, 100.

[58] Changed Policy Concerning the Granting of Sovereign Immunity to Foreign Governments (Tate Letters), 26 DEP'T ST. BULL. 984 (1952).

[59] Rubintoola v. Nizam of Hyderbed, [1957] 3 W.L.R. 884, 913, 3 All E.R. 441, 463.

[60] Trendtex Trading Corp., Ltd. v. Central Bank of Nigeria, [1977] 1 All E.R. 881; *see*

engaged in an ambitious program of development, had obligated itself to buy a vast quantity of cement which was crucial to the construction of its infrastructure. It had executed 109 contracts with 68 suppliers for over 16 million metric tons at a price approaching one billion dollars. As it turned out, however, the government had overbought. In July 1975, the ports of Lagos and Apapa were congested with shipping. The docks were completely filled, and ships were waiting to discharge their cargoes. It is estimated that there were between 300 and 400 ships waiting to unload; more vessels with cement were on the way. At this point a new government took power and immediately tried to solve the problem. It issued a notice suspending the shipment of cement to Nigeria. It then directed the Central Bank of Nigeria to telex its correspondent banks abroad to withhold payment in respect of letters of credit opened by the Central Bank in favor of the sellers of the cement unless, in addition to the documents required by the letters of credit, they were in receipt of Nigerian Government clearance certificates authorizing the shipments.[61]

Trendtex, the plaintiff, was the beneficiary of a commercial letter of credit issued by the Central Bank and advised through its London correspondent Midland Bank. The latter acted only as agent in the transaction and was not asked to confirm the irrevocable commercial credit of the Central Bank. The credit was made expressly subject to the provisions of the Uniform Customs and Practice for Documentary Credits and was in respect of a contract entered into by the Ministry of Defense for the purchase of cement.[62]

When Trendtex presented the documents called for by the credit together with sight drafts to Midland Bank, the bank, under instructions from its principal the Central Bank of Nigeria, refused to make payment. The plaintiff then brought suit for damages against Central Bank arising from the failure of the issuing bank to authorize payment in accordance with the terms of the credit and obtained an injunction ordering the defendant to retain within the court's jurisdiction a sum of money sufficient to meet the plaintiff's claim.[63]

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also Texas Trading v. Fed. Rep. of Nigeria, 647 F.2d 300, 302 (2d Cir. 1982).

[61] [1977] 1 All E.R. at 885-87.

[62] *Id.* at 885-86.

[63] *Id.* at 886-87.

The Court of Appeal[64] applied the absolute doctrine of sovereign immunity and held for the Central Bank. It ordered the discharge of the injunction. The Court reasoned that simply because the Central Bank had been established as a legal entity and was not characterized in its enabling law as a government department, this did not preclude it from being considered a part of the machinery of government if its principal functions were essential functions of the state which were not provided by another body.[65] After an exhaustive analysis of the functions of the Central Bank, the Court concluded that the Central Bank was indeed an extension of the Nigerian Government. The Court based this decision upon such factors as the prime functions of the Central Bank, currency control and treasury activity, which are essentially state activities.[66] The Court recognized that the Central Bank had some discretion in deciding how to conduct its affairs but concluded that the discretion was exercised on behalf of the interest of the state and not of the Central Bank.[67]

On further appeal, the decision was reversed and the injunction reinstated.[68] The common ground of all three judges was that the defendant had not established that it was a department or organ of Nigeria and, therefore, it was not entitled to the plea of sovereign immunity in respect of the suit.[69] To this extent the doctrine of absolute immunity was employed, but the Court found the evidence insufficient to satisfy its requirements.[70]

A secondary ground on which two of the judges agreed was that even if it had been established that the defendant was a department or organ of the state, it could not plead sovereign immunity with respect to an ordinary commercial transaction.[71] This ground rests on the recognition of the restrictive theory of sovereign immunity. All three judges agreed that the issue of the immunity of the funds from seizure depended upon the immunity or lack thereof of the defendant.[72]

In deciding that the plea of sovereign immunity would no longer

[64] Trendtex Trading Corp., Ltd. v. Central Bank of Nigeria, [1976] 3 All E.R. 437.
[65] *Id.* at 443.
[66] *Id.* at 444.
[67] *Id.*
[68] Trendtex, [1977] 1 All E.R. at 881.
[69] *Id.*
[70] *Id.* at 907.
[71] *Id.* at 892, 908.
[72] *Id.* at 895, 905, 911.

be accorded to ordinary trading transactions and that the restrictive doctrine of immunity should be applied to actions in personam,[73] the Court had dealt the absolute theory a lethal blow. Lord Denning, who earlier had questioned the absolute theory, now explained his support for the restrictive theory. Reflecting on the activities of modern sovereign states, he said:

> They charter ships. They buy commodities. They issue letters of credit. This transformation has changed the rules of international law relating to sovereign immunity. . . . [The doctrine of restrictive immunity] gives immunity to acts of a governmental nature . . . but no immunity to acts of a commercial nature. . . .[74]

Lord Denning concluded that regardless of the ultimate purpose of the transaction, it was the nature of the transaction that was critical.[75] Therefore, the fact that the Nigerian Government wished to use the cement for a government purpose was irrelevant. What was crucial was that it had chosen to enter the market place.[76]

The Restrictive Theory of Sovereign Immunity: United Kingdom

In the year following the *Trendtex* decision, the United Kingdom enacted the State Immunity Act of 1978[77] based on the European Convention on State Immunity[78] and incorporating the re-

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[73] Immunity was refused in actions in rem against state-owned ships carrying on commercial activities in Phillippine Admiral v. Willem Shipping (Hong Kong) Ltd., [1976] 1 All E.R. 78.

[74] Trendtex, [1977] 1 All E.R. at 890.

[75] *Id.* at 893. Lord Denning stated:

> It was suggested that the original contracts for cement were made by the Ministry of Defense of Nigeria, and that the cement was for the building of barracks for the army. On this account it was said that the contracts of purchase were acts of a governmental nature—jure imperii—and not of a commercial nature—jure gestionis. They were like a contract of purchase of boots for the army. But I do not think this should affect the question of immunity. If a government department goes into the market places of the world and buys boots or cement—as a commercial transaction—that government department should be subject to all the rules of the market place. The seller is not concerned with the purpose to which the purchaser intends to put the goods.

Id.

[76] *Id.*

[77] An Act to make new provision with respect to proceedings in the United Kingdom; by or against other states; to provide for the effect of judgments given against the United Kingdom in the courts of state parties to the European Convention on State Immunity; to make new provision with respect to the communities and privileges of the Heads of State; and for connected purposes [State Immunity Act], 1978, ch. 33.

[78] European Convention on State Immunity and Additional Protocol, May 16, 1982,

strictive theory of sovereign immunity. The Act distinguishes between immunity from suit and immunity from attachment and execution.

The formal structure of the Act provides that a foreign sovereign state is immune from suit in the jurisdiction of the courts of the United Kingdom except as it otherwise expressly provides. The Act then sets out the circumstances in which a state is not immune. It is not immune if it submits to the jurisdiction of the courts. If the state has not submitted to such jurisdiction but the proceedings relate to a commercial transaction entered into by the state then, unless otherwise agreed in writing by the parties, immunity will not attach.[79] "Commercial" is defined in section 3(3) as:

> (a) any contract for the supply of goods or services;
> (b) any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation; and
> (c) any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a State enters or in which it engages otherwise than in the exercise of sovereign authority. . . .[80]

The Act further provides that a state is not immune from proceedings that relate to a contractual obligation of the state (whether a commercial transaction or not) which is to be performed wholly or partly in the United Kingdom. An exception is made if the contract was made in the territory of the state concerned and if the obligation is governed by that state's administrative law.[81] Further circumstances in which a state is not immune from legal proceedings are set out in sections 4 through 8 of the Act. These circumstances are characterized by the restrictive theory of sovereign immunity as acts not performed in the exercise of sovereign authority.[82]

Despite this substantial turnabout in situations in which a state may no longer plead immunity from suit in legal proceedings,

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Europ. T.S. 74, *reprinted in* 11 I.L.M. 470 (1972). *See* Sinclair, *The European Convention on State Immunity*, 32 INT'L & COMP. L.Q. 254 (1973).

[79] State Immunity Act, 1978, ch. 33, § 3. The exceptions from immunity made by section 3 do not apply if the two parties to the dispute are states. *Id.* § 3(2).

[80] *Id.* § 3(3).

[81] *Id.* § 3(2).

[82] *See supra* notes 58-59 and accompanying text.

under the Act a state will be largely immune from the interlocutory relief of attachment and execution in aid of judgment unless the state gives written consent. This consent will not be inferred from a mere submission to the jurisdiction of the courts. Accordingly, section 13(2)(a) provides that relief will not be given by way of an injunction, and section 13(2)(b) provides that "the property of a state shall not be subject to any process for the enforcement of a judgement or arbitration award or, in an action in rem, for its arrest, detention or sale."[83] An exception, however, is made to the last rule by section 13(4), which permits the issue of process respecting property that is "in use or intended for use for commercial purposes. . . ."[84] This exception is qualified when a central bank is the party in question. The property of a central bank or other monetary authority is immune from enforcement unless its consent to such enforcement is obtained. Section 13(4) does not apply to a central bank or other monetary authority since the property of such bodies is not to be regarded as in such use or intended to be used in that way.[85] The net effect is that central banks and monetary authorities under the Act will have no immunity from suit in respect to commercial transactions, but they will have full immunity from attachment or execution against their property without their consent. It is irrelevant whether the bank or authority is a separate entity from the state or is a government agency.[86]

The Result if the Trendtex Case Had Arisen After the U.K. Act

The Central Bank would not have been immune from suit if the case had arisen after the passage of the Act. It would not have been immune from suit because section 3 of the Act reflects the decision of the Court of Appeal in that case.[87] This conclusion follows whether or not the Central Bank is considered a separate entity from the Nigerian Government. If the Central Bank were con-

[83] State Immunities Act, 1978, ch. 33, § 13(2)(b).

[84] *Id.* § 13(4).

[85] *Id.*

[86] The Act provides that it is not to be given retroactive effect. Accordingly, when suit was brought against the Central Bank of Nigeria by another plaintiff in Hispano Americana Mercantil S.A. v. Central Bank of Nigeria, based on the same facts the court held that as to the injunction, as well as to sovereign immunity, the decision in *Trendtex* governed the case. [1979] 2 Lloyd's L.R. 277, 279.

[87] *See supra* notes 77-86 and accompanying text. *See also* Sinclair, *Organs of the State—Immunity of Organs of the State—Immunity Other than Diplomatic*, 1980 BRIT. Y.B. INT'L L. 422, 429 (1980).

sidered part of the government, it would not have immunity from suit since the letter of credit would constitute a "commercial transaction" within the meaning of section 3(1)(a) and section 3(3).[88] If, on the other hand, the Central Bank were considered as a separate entity from the government, it would not be immune from suit insofar as its protection from suit would then parallel that which would be accorded to a state under the same circumstances.[89]

A different result would be obtained on the question of immunity from an injunction against removing assets from the jurisdiction of the Court.[90] While the Court of Appeal in the *Trendtex* case allowed an injunction to prevent the Central Bank from removing its assets from the jurisdiction, the State Immunity Act grants to foreign monetary authorities and central banks absolute protection from any form of attachment or execution.

The Restrictive Theory of Sovereign Immunity: Federal Republic of Germany

In the Federal Republic of Germany, a case growing out of substantially the same facts as those litigated in *Trendtex* was decided by the District Court of Frankfurt in December 1975. In that case, *Nonresident Petitioner v. Central Bank of Nigeria*,[91] the district court found it unnecessary to consider whether the Central Bank could successfully assert sovereign immunity on the basis of being bound by government instructions and of having to implement the government's financial policies. Such an inquiry was unnecessary because even if the Central Bank were an integral instrumentality of the Nigerian Government, it could not claim immunity on the facts of the case. The court applied the restrictive theory of immu-

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[88] This same conclusion would be reached if it were considered under section 3(1)(b) as "an obligation of the state which by virtue of a contract (whether a commercial transaction or not) calls to be performed wholly or partly in the United Kingdom." State Immunities Act, 1978, ch. 33, § 3(1)(b).

[89] Section 14(2) of the Act provides:

> A separate entity is immune from the jurisdiction of the courts of the United Kingdom if, and only if —
>
> (a) the proceedings relate to anything done by it in the exercise of sovereign authority; and
>
> (b) the circumstances are such that a State (or, in the case of proceedings to which section 10 above applies, a State which is not a party to the Brussels Convention) would have been so immune.

State Immunities Act, 1978, ch. 33, § 14(2).

[90] *See* Sinclair, *supra* note 87, at 435. *See also* Marston, *State Immunity—Recent U.K. Developments*, 13 J. WORLD TRADE L. 349, 353 (1979).

[91] 15 I.L.M. 501 (1977) (Federal Republic of Germany).

nity, stating that a foreign state is exempt from the jurisdiction of German courts only in regard to its governmental activities. In accordance with this theory, the court found that German law must govern the characterization of the transaction in question. The test was the nature of the transaction rather than its purpose.[92] On that basis, the court rejected the defendant's contention that Nigerian law would characterize the transaction differently (having reference to the purchase of cement for construction of military installations and the assumption of a payment obligation incident thereto as a governmental activity).[93] The decisive factor was that a letter of credit had been issued and that the dispute turned on the obligations of the defendant in accordance therewith.[94]

As for the question of the attachment of the local assets pending disposition of the case on its merits, the court took the same position that the English Court of Appeal subsequently adopted in *Trendtex*.[95] The Frankfurt District Court decided that if jurisdiction over the foreign state exists, then attachment of the local assets of the foreign state is permissible. The court further held that the only assets immune from attachment were those funds dedicated to public use at the time of the petition for attachment.[96]

The Restrictive Theory of Sovereign Immunity: United States

The Central Bank of Nigeria was also sued in the United States for its failure to carry out its obligations in accordance with irrevocable letters of credit issued by it and advised through the Morgan Guaranty Trust Company of New York. Payments were to be made on the Central Bank's behalf by Morgan Guaranty Trust Company upon presentation to Morgan of sight drafts and other specified documents. When the United States company presented

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[92] *Id.* at 503.

[93] The court stated:

> pursuant to German law which governs the characterization, the execution of a sales contract and payment thereunder by the Nigerian Ministry of Defense by means of a letter of credit are not activities *jure imperii* in any sense of the term. . . .The respondent is, therefore, according to applicable German law, not exempt from the jurisdiction of German courts.

Id. at 504.

[94] *Id.* at 503. The court held that "[p]etitioner's claims do not arise from sovereign activities of the respondent but from the latter's private transactions, viz., the establishment of a letter of credit at a bank." *Id.*

[95] This is no longer the rule in the United Kingdom as a result of the enactments of the State Immunity Act. *See* State Immunity Act, 1978, ch. 33, § 3.

[96] 15 I.L.M. at 503.

the drafts and other documents specified by the letters of credit, Morgan, acting on the instructions of the Central Bank, refused payment for cement deliveries and demurrage charges in the absence of additional documents (not called for by the letters of credit) indicating that plaintiffs had given two months' advance notice of the departure of ships transporting the cement and that official clearance for such departures had been given.[97]

As with cases brought in other countries, no United States court granted the Central Bank of Nigeria immunity from the legal proceedings. In addition, the earlier cases which were decided under the laws of New York held that the Central Bank's funds on deposit in New York banks were subject to attachment prior to judgment.[98] As a consequence of the provisions of the Foreign Sovereign Immunities Act of 1976,[99] cases brought after the Act went into force do not involve attachment proceedings.[100]

The United States Act is in many ways similar to the U.K. Act because both are based on the restrictive theory of sovereign immunity and because their structures are similar. Thus, the United States Act provides that a state is immune from suit (in both state and federal courts) except where specifically permitted. The United States Act also is divided into provisions concerning immunity from legal proceedings and that from attachment and enforcement of judgments against the property of a foreign state.[101]

Under section 1605 of the Act exceptions from immunity are made for a number of cases including, among others, those involving express or implied waivers and those involving the commercial

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[97] *See* Texas Trading and Milling Corp. v. Fed. Rep. of Nigeria, 647 F.2d 300 (2d Cir. 1981).

[98] *See* National American Corp. v. Fed. Rep. of Nigeria and Central Bank of Nigeria, 448 F. Supp. 622 (E.D. Penn. 1978), *aff'd*, 597 F.2d 314 (2d Cir. 1979); National Bank and Trust Company of North America, Ltd. v. J.L.M. International, Inc., 421 F. Supp. 1269 (S.D.N.Y. 1969). *See generally* Nwogugu, *Immunity of State Property—The Central Bank of Nigeria in Foreign Courts*, [1979] NETH. Y.B. INT'L L. 179.

[99] Foreign Sovereign Immunities Act, 28 U.S.C. §§ 1330, 1332(a)(2)-(4), 1391(4), 1441(d), 1602-1611 (1976). *See generally* Kahale and Vega, *Immunity and Jurisdiction: Toward a Uniform Body of Law in Actions against Foreign States*, 18 COLUM. J. TRANSNAT'L L. 211 (1979).

It should be noted that the United States Supreme Court has upheld the constitutionality of section 1330(a) of the Act in a suit between a foreign plaintiff and a foreign sovereign growing out of the cement controversy involving the Central Bank of Nigeria. *See* Verlinden BV v. Bank of Nigeria, 647 F.2d 320 (2d Cir. 1981), *rev'd*, 103 S. Ct. 1962 (1983).

[100] Attachment of assets of foreign states for jurisdictional purposes is now precluded. 28 U.S.C. § 1609.

[101] *Id.* §§ 1604-1605, 1609-1611.

activity of foreign states, provided that such activity has the necessary jurisdictional nexus with the United States.[102]

If the activity sued upon is "governmental" rather than "commercial," a foreign state is entitled to immunity from suit. Since section 1605 depends on the interpretation of "commercial activity," the Act provides a definition of this term in subsection 1603(d):

> (d) A 'commercial activity' means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose.[103]

In accordance with these parameters, the United States Court of Appeals for the Second Circuit, considering four appeals from the district court with facts substantially similar to those on which *Trendtex* was decided, held in *Texas Trading and Milling Corp. v. Federal Republic of Nigeria and Central Bank of Nigeria*[104] that jurisdiction existed under the Foreign Sovereign Immunities Act and that the defendants had sufficient contacts with the United States to allow the suit on the basis of personal jurisdiction.[105] The court noted that despite article 3 of the Uniform Customs and Practices for Documentary Credits, providing that irrevocable letters of credit cannot be modified or cancelled without the consent of all interested parties, the defendants had attempted a unilateral alteration of the letters of credit. The letters of credit as well as the cement contracts constituted "commercial activity" within the meaning of the Act and hence the defense of sovereign immunity was denied.[106]

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[102] *Id.* §1605. This section states in part:

> (a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case — .
>
> . . .
>
> (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.

Id.

[103] *Id.* § 1603(b).

[104] 647 F.2d 300 (2d Cir. 1981).

[105] *Id.* at 313-15.

[106] *Id.* at 310.

Although the court in *Texas Trading* did not consider the possibility of an attachment of the Central Bank's property to aid execution upon the judgment, a few words may be in order concerning the treatment by the Act of the immunity from attachments.

The Act sets forth procedures governing service on and obtaining default judgment against a foreign state and its agencies or instrumentalities. Attachments are precluded as a means of commencing a suit.[107] The use of attachments in aid of execution or from execution upon a judgment, however, is permitted in certain circumstances under section 1610 of the Act. Section 1610(a)(2) denies immunity from attachment in aid of execution or execution upon a judgment against property used by a foreign state for a commercial activity in the United States if the claim upon which the judgment was based grew out of that activity.[108] Section 1610(b)(2) denies such immunity to the property of an agency or instrumentality of a foreign state engaged in commercial activity in the United States if the judgment relates to a claim involving commercial activity carried on in the United States (or in certain circumstances elsewhere).[109] These provisions in section 1610 are restricted by section 1611 which specifically grants immunity from attachment to central bank funds of foreign countries. Under section 1611 such funds are immune unless such immunity is explicitly waived by the bank or its parent government.[110]

IV. IMPLICATIONS OF CERTAIN BANK FAILURES AND EXPROPRIATIONS

An Ominous Series of Failures

A series of failures experienced a few years ago by well known banks has generated concern in international banking circles. The

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[107] 28 U.S.C. § 1609.

[108] *Id.* § 1610(a)(2).

[109] *Id.* § 1610(a)(2).

[110] *Id.* § 1611(b)(1). This provision:

> applies to funds of a foreign central bank or monetary authority which are deposited in the United States and 'held' for the bank's or authority's 'own account' —i.e., funds used or held in connection with central banking activities, as distinguished from funds used solely to finance the commercial transactions of other entities or of foreign states. If execution could be levied on such funds without an explicit waiver, deposit of foreign funds in the United States might be discouraged. Moreover, execution against the reserves of foreign states could cause significant foreign relations problems.

H.R. REP. No. 94-1487, 94th Cong., 2d Sess. 31, *reprinted in* 1976 U.S. CODE CONG. & AD. NEWS 6604, 6630.

series includes the failures of Intra Bank in Beirut in 1966, United States National Bank in San Diego in 1973, Bankhaus I.D. Herstatt of Cologne in 1974, and Franklin National Bank of New York in the same year. In all these cases, the effects were contained despite the international component of some of the contributing causes of the failures. There was no uncontrolled chain reaction that might have brought down a number of banks in different countries. Nevertheless, the failures of these banks and the buildup of international sovereign debt have led bank regulatory authorities in a number of countries to reassess the dangers in the current situation.[111] Certain implications of this chain of failures, implications of certain recent expropriations, and the responses of the courts and of regulatory agencies will be considered.

It is difficult to attribute all of the cases of failure to any single cause. Standby letters of credit were involved significantly in only one case, that of the United States National Bank. However, they also made their appearance in the failure of the New York branch of Intra Bank.

On October 18, 1973, the United States Comptroller of the Currency declared the United States National Bank in San Diego insolvent. One important cause for the failure was found to be the issuance by the bank of about $90 million in standby credits. Many of these credits had been issued by the bank to cover loans extended by other banks to the bank's president.[112] When these other banks sought repayment from the Federal Deposit Insurance Company (FDIC), which had been appointed receiver of the bank, the FDIC refused, and suit was brought. While the district court initially ruled in favor of the FDIC, the court of appeals ruled that the equal treatment protection of creditors provisions of the National Bank Act required the FDIC to take account of the plaintiffs' claims.[113]

The regulatory response to this failure was to require standby credits to be included within the legal limitations which are applicable to lending to individual borrowers.[114] Bills that would further

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[111] *See* STAFF OF SENATE SUBCOMM. ON FOREIGN ECONOMIC POLICY, 95TH CONG., 1ST SESS, REPORT ON INTERNATIONAL DEBT, THE BANKS, AND U.S. FOREIGN POLICY (Comm. Print 1977).

[112] *See Failure of the U.S. National Bank of San Diego: Hearings Before the Subcomm. on Bank Supervision and Insurance of the House Comm. on Banking and Currency*, 93d Cong., 2d Sess. (1974); *see also* Verkuil, *Bank Solvency and Standby Letters of Credit: Lessons from the USNB Failure*, 53 TUL. L. REV. 314 (1979).

[113] First Empire Bank v. FDIC, 572 F.2d 1361, 1371 (9th Cir. 1978).

[114] *See* 12 C.F.R. §§ 337.2, 7.1160, 208.8(d) (1983).

limit the issuance of standby credits have been introduced in Congress but have not been passed into law.[115]

In the earlier Intra Bank affair, letters of credit were involved incidentally in connection with the circumstances surrounding the closure of the New York branch. Intra Bank had been incorporated in Lebanon and had branches throughout the world. In October 1966, a liquidity crisis arose when deposits were shifted from Beirut to London. A run on the bank developed in Lebanon, and the banking authorities decided not to intervene. On the same day that the Beirut office closed its doors, the New York branch was closed by the New York Superintendent of Banks. Although initially an examination of the books and accounts indicated that the excess of assets over liabilities required by New York law (108% rule)[116] had been maintained, it was subsequently discovered that over $21 million in standby credits, which did not appear on the balance sheet, were in fact contingent liabilities of the branch. If these contingent claims had been honored, the branch would have been found to be in violation of the New York law. Initially the New York Superintendent of Banks rejected these claims. Fortunately, an unlisted asset was discovered in the form of the branch's office building, and the proceeds of its sale contributed to a compromise with the creditors.[117]

The use of New York law, which was a controlling factor in the claims arising out of the Intra Bank branch closure, is one approach to assure local depositors and creditors of a branch of a

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[115] *See* Harfield, *The Standby Letter of Credit Debate*, 94 BANKING L.J. 293 (1977); Katzkee, *The Standby Letter of Credit Debate—The Case for Congressional Resolution*, 92 BANKING L.J. 697 (1975).

[116] N.Y. BANKING LAW § 202-b(2) (McKinney Supp. 1982). The provision required at the time of the Intra Bank affair that the assets held in New York be not less than 108% of the liabilities of the branch:

> Each foreign banking corporation shall hold in this state currency, bonds, notes, debentures, drafts, bills of exchange or other evidences of indebtedness or other obligations payable in the United States or in United States funds or, with the prior approval of the superintendent, in funds freely convertible into United States funds, in an amount which shall be not less than one hundred eight per centum of the aggregate amount of liabilities of such foreign banking corporation payable at or through its branch or branches in this state, including acceptances, but excluding (1) accrued expenses, and (2) amounts due and other liabilities to other offices or branches of, and wholly owned (except for a nominal number of directors' shares) subsidiaries of, such foreign banking corporation.

Id.

[117] *See* Intra Bank v. Willie, 296 N.Y.S.2d 283 (1968), *aff'd mem.*, 25 N.Y.2d 619, 306 N.Y.S.2d 7 (1969), *cert. denied*, 399 U.S. 910 (1970). *See also* Verkuil, *Bank Solvency and Guaranty Letters of Credit*, 25 STAN. L. REV. 716, 729 (1973).

foreign bank that, in the event of the insolvency of the latter, sufficient assets will be available to cover local claims against the branch.[118] This type of requirement is not common, however, and the responsibilities both of parents for their foreign branches and of the appropriate banking regulatory authorities of the different jurisdictions have raised broader problems of policy. The circumstances testing these responsibilities differ. With regard to parents of foreign branches, they tend to involve the expropriation of a foreign branch while with regard to banking regulatory authorities, they tend to involve the failure of the parent or its foreign branch.

The Liability of Parent Banks for Obligations Incurred by Their Foreign Branches

As a general rule of corporate responsibility, the obligations of a branch of a corporation are considered those of the corporation. With respect to banks, the Attorney General of the United States stated in a 1909 opinion that:

> [t]he branch banks have no separate corporate existence. . . .The parent bank with its branches is one association, as contemplated in these laws, with one set of directors and stockholders, and all transactions are regarded as those of one corporation. . . . [D]epositors . . . in any of the branch banks have the protection of the whole capital, surplus, and undivided profits of the mother bank, irrespective of how it may be divided. . . .[119]

The specific question of the responsibility of a parent for foreign branches was answered similarly in 1917 by the Counsel of the Federal Reserve Board. The question before him was whether "[i]n

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[118] N.Y. BANKING LAW § 202-b(2). This act now reads, in part:

> Each foreign banking corporation shall hold in this state currency, bonds, notes, debentures, drafts, bills of exchange or other evidences of indebtedness, including loan participation agreements or certificates, or other obligations payable in the United States or in United States funds or, with the prior approval of the superintendent, in funds freely convertible into United States funds, or such other assets as the superintendent shall by rule or regulation permit, in an amount which shall bear such relationship as the banking board shall by regulation prescribe to liabilities of such foreign banking corporation payable at or through its agency, agencies, branch or branches in this state, including acceptances, but excluding amounts due and other liabilities to other offices, agencies or branches of, and wholly owned (except for a nominal number of director's shares) subsidiaries of, such foreign banking corporation and such other liabilities as the superintendent shall determine.

Id.

[119] 27 Op. Att'y Gen. 601, 602-05 (1909).

the event of the failure of a national bank having branches in foreign countries, would the creditors of the branches become general creditors of the bank with which they were doing business."[120] The conclusion of the Counsel was that "creditors of a branch of a national bank [abroad] would . . . be general creditors of the parent bank and would be permitted to prove their claims in the same manner as local creditors."[121]

This question has recently been litigated in two different forms. In *First National Bank of Boston (International) v. Banco Nacional de Cuba*,[122] branches of First National in Cuba had issued commercial letters of credit for the account of Cuban importers seeking to buy foreign goods. In most cases the buyers had deposited Cuban pesos before the issuance of the credits. The letters of credit had then been confirmed at First National's Boston office. After shipping goods to the Cuban buyers, sellers had presented their confirmed credits, together with the appropriate shipping documents, to the Boston office for payment in dollars. On September 17, 1960 Cuba nationalized all of First National's Cuban branches and placed Banco Nacional in charge. The credits presented at First National's Boston office were paid. When Banco Nacional failed to reimburse First National for the letter of credit payments made in Boston, plaintiff brought suit claiming that the Cuban branches had been liable to First National on the letters of credit and that as a result of the nationalization Banco Nacional had assumed all liabilities of the branches.[123] The court of appeals found for Banco Nacional. The court reasoned that First National and its Cuban branches were not distinct entities but were part of the same parent corporation and as such any obligations owed to each other were merely a matter of internal bookkeeping, not matters of substance.[124]

In *Vishipco Line v. Chase Manhattan Bank, N.A.*,[125] plaintiffs included several Vietnamese corporations that maintained piastre demand deposit accounts at Chase's Saigon branch in 1975. In addition, one individual plaintiff, a Vietnamese citizen, had purchased a certificate of deposit from Chase's Saigon branch in 1974.

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[120] *See* Heininger, *Liability of U.S. Banks for Deposits Placed in Their Foreign Branches*, 11 LAW & POL'Y INT'L BUS. 903, 924 (1979).
[121] *Id.*
[122] 658 F.2d 895 (2d Cir. 1979).
[123] *Id.* at 899.
[124] *Id.* at 900-01.
[125] 660 F.2d 854 (2d Cir. 1981).

On April 24, 1975 Chase closed its Saigon branch without prior notice to depositors. Thereafter, a new government took control of Saigon and issued a communique announcing that all banks would be confiscated and managed by the revolutionary administration. When plaintiffs sought recovery from Chase's New York office of the dollar value of the piastre deposits held by the Saigon branch for them at the time of its closure and of the dollar value of the certificate of deposit, Chase refused payment. Chase argued that the seizure of its former branch in Saigon and the appropriation of its assets relieved it of any liability to the plaintiffs.[126] The court of appeals reversed the lower court's decision which had been rendered in favor of Chase and remanded for further proceedings in accordance with its opinion. The court stated that in order for Chase to prevail it must show that the Vietnamese Government more than merely confiscated the corporate assets. It must also show that the government formally assumed the assets and liabilities of the corporation.[127] The court concluded that the seizure involved only the physical assets of Chase in Vietnam and did not extend to any claims the plaintiffs may have.[128] In support of this conclusion, the court noted that Chase had already abandoned its Vietnamese branch at the time of the communique and that it could not have had any effect on the debt to plaintiffs.[129]

The question of whether a decision in favor of a depositor might require a parent bank of a nationalized branch to meet the latter's liabilities at a time when its assets had been seized was the subject of judicial comment in *Esther G.M. Perez v. Chase Manhattan Bank*.[130] In that case the plaintiff in 1958 had obtained five certificates of deposit from the defendant bank's branch in Havana. In September 1959 the new Cuban Government of Fidel Castro ordered Chase to close certain frozen accounts, including those of the plaintiff, and to pay the proceeds to the government. Subsequently, the branch was nationalized, its assets confiscated, and the liabilities assumed by the government. The branch was thereafter placed under the operation of Banco Nacional de Cuba. In 1974, the plaintiff, who had by this time emigrated from Cuba, demanded payment on the certificates of deposit of Chase in New

[126] *Id.* at 857.
[127] *Id.* at 861.
[128] *Id.*
[129] *Id.* at 862.
[130] 93 A.D.2d 402 (1983).

York. Chase refused to make payment, contending that the obligations were solely of the branch and that the Cuban Government had both seized the branch's assets and acquired its liabilities.[131] The trial court granted judgment for the defendant[132] as a matter of law, and the plaintiff appealed. The Supreme Court, Appellate Division, unanimously reversed judgment and directed it in favor of the plaintiff. In the course of its decision, the court found the Act of State doctrine inapplicable to the situation at hand.[133] As to the argument that Chase would, in effect, be paying twice, the court stated that a failure to rule for the plaintiff would actually prove to be a windfall for banks in Chase's position. The court reasoned that since funds collected from one branch of a bank are often loaned out and invested, the loss from a seizure and confiscation is far from one hundred percent. The result of Chase's position, therefore, would be to free the bank of all liability in the country in question while only a portion of its assets had been lost.[134]

It should be noted that this case goes beyond *Vishipco* insofar as the court in *Vishipco* relied on a showing only that the Vietnamese Government had confiscated the assets of the branch without also assuming its liabilities.[135] In *Perez*, however, the court found that the Cuban Government not only had seized the branch's assets, but also had acquired its liabilities.[136] This finding did not, however, deflect the court from awarding judgment in favor of the plaintiff and against the bank in whose branch the deposit had been made.

While the courts were adjudicating the responsibility of parent banks for the obligations of their foreign branches, banking supervisory authorities in a number of countries have been seeking to work out guidelines to cover the authorities' responsibilities where banks operate in different countries.

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[131] *Id.* at 402-04.

[132] *Id.*

[133] Esther G.M. Perez v. Manhattan Bank, 93 A.D.2d 402, 463 N.Y.S.2d 764 (1983). The United States Supreme Court defined the Act of State doctrine in Underhill v. Hernandez, 168 U.S. 250, 252 (1897). "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 another done within its own territory." *Id. See also* Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 428 (1964). Congress sought to modify the application of the doctrine in the Hickenlooper Amendment, which has been codified in 22 U.S.C. § 2370 (1981).

[134] 463 N.Y.S.2d at 770.

[135] *See supra* notes 125-129 and accompanying text.

[136] *See supra* notes 130-134 and accompanying text.

The Responsibility of the Banking Regulatory Authorities Where Banks Operate in Different Countries

The Committee on Banking Regulations and Supervisory Practices (Cooke Committee)[137] was established by the Central Bank Governors of the Group of Ten Countries in 1974 following a series of bank failures.[138] It was formed to facilitate cooperation and contact among the banking supervisors of the various nations. In the course of its work it has attempted to set out a division of supervisory responsibility with respect to banks operating abroad. This division has come to be known as the Concordat.[139] Banking supervisors of various authorities examined the Concordat in London in 1979 and in Basle in 1980. Although no formal decisions were taken and although the Concordat has no binding legal obligation, the various authorities were able to express general acceptance of its principles.

It should be noted that neither in its initial nor in its revised version does the Concordat seek to establish which authority should be the lender of last resort in the various situations that may be encountered.[140] As initially agreed, however, it did attempt to suggest guidelines and recommendations on the following matters:

(1) foreign banking supervision should be the joint responsibility of both the authorities in the parent country and those in the host country;

(2) all foreign banking establishments should be supervised in a manner judged adequate by both host and parent authorities;

(3) the supervision of liquidity should be primarily the responsibility of the host authorities;

(4) the supervision of solvency of foreign branches should be essentially the responsibility of the parent authorities. For foreign subsidiaries, primary responsibility should rest with the host authorities, but parent authorities should take account of the exposure of their domestic banks' foreign subsidiaries and joint ventures;

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137 This Committee is named for its chairman, Mr. Peter Cooke of the Banking Supervision Division of the Bank of England.

138 *See supra* note 111 and accompanying text.

139 *Supervision of Banks' Foreign Investment*, INTERNATIONAL CAPITAL MARKETS, Aug. 1981, at 29 [hereinafter cited as Concordat].

140 *Id.* at 29-32; *Principles of Supervision of Banks' Foreign Establishments*, INTERNATIONAL CAPITAL MARKETS, July 1983, at 49 [hereinafter cited as Revised Concordat].

(5) cooperation may be enhanced by transfers of information between host and parent authorities and by the authorization of examinations conducted by or on behalf of parent authorities in the jurisdiction of the host authorities.[141]

Additional recommendations were made beginning in 1978 to embody the principle that international banking business should be supervised on a consolidated basis. This principle relates capital adequacy and risk exposure to the entire business of a bank including its branches, subsidiaries, and affiliates overseas so that the parent authorities can evaluate these factors in a global perspective. A number of countries have revised their supervisory practices in accord with this principle. Moreover, a directive requiring members of the European Community to bring their regulations and procedures into accord with supervision on a consolidated basis was adopted by the Council of Ministers of the Community on June 13, 1983.[142]

One bank crisis has tested the Concordat. As early as 1978, the Bank of Italy was concerned with the affairs of the Milan-based Banco Ambrosiano. In that year its investigators submitted a report concerning the bank's foreign subsidiaries and the dealing in the bank's shares by its president, Roberto Calvi. Mr. Calvi was subsequently tried for currency offenses in 1981. By the middle of 1982, Mr. Calvi had fled the country and was found dead in London under mysterious circumstances. Banco Ambrosiano collapsed and was closed by the authorities; it was subsequently reorganized with full protection for depositors. A controversy centered about Banco Ambrosiano's Luxembourg subsidiary, Banco Ambrosiano Holdings.[143]

At the time of the parent's failure, the Luxembourg subsidiary was indebted to third parties, largely international banks, in excess of $400 million. While some of its creditors expected the Bank of Italy to assume responsibility for these debts, the Bank of Italy steadfastly refused to do so. The position of the Bank of Italy was that the Concordat sets out a division of responsibilities concerning control and supervision but does not purport to assign lender

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[141] Concordat, *supra* note 139, at 29-32; *see also* Frydl, *The Eurodollar Conundrum*, 7 FED. RES. BANK OF N.Y.Q. REV. 11, 14 (Spring 1982) (citing Cooke, "Developments in Cooperation Among Banking Supervisory Authorities," presented at a Conference on the Internationalization of Capital Markets, March 19-21, 1981).

[142] *Supervision of Credit Institutions on a Consolidated Basis*, INTERNATIONAL CAPITAL MARKETS, July 1983, at 54.

[143] The Financial Times, Nov. 17, 1982, § 3, at 2, col. 1.

of last resort responsibilities. For their part, the Luxembourg banking authorities noted that the subsidiary holding company was technically not a bank and hence was not within their supervisory responsibility.[144] Precise responsibility for the matter had thus fallen between two stools.

With a gap of this magnitude in evidence, central bankers met in Basle in May 1983 to approve revisions to the Concordat.[145] In addition to incorporating the principle of consolidated supervision into the new revision, several other changes are reflected. Of particular interest is language that is intended to address the problems that arose out of the Banco Ambrosiano affair: "Where a bank is the parent company of a group that contains intermediate holding companies, the parent authority should make sure that such holding companies and their subsidiaries are covered by adequate supervision."[146]

The new Concordat also includes recommendations concerning joint ventures or consortia. Supervision of both their solvency and liquidity is primarily the responsibility of the authorities in the country of incorporation. Specific mention is also made in the new Concordat of foreign exchange operations and positions, supervi-

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[144] *Id.*

[145] *See World Banking Guidelines*, N.Y. Times, June 9, 1983, § D, at 6, col. 6.

[146] Revised Concordat, *supra* note 140, at 48-53. The Revised Concordat states in part:

> gaps in supervision can arise out of structural features of international banking groups. For example, the existence of holding companies either at the head, or in the middle, of such groups may constitute an impediment to adequate supervision. Furthermore, particular supervisory problems may arise where such holding companies, while not themselves banks, have substantial liabilities to the international banking system. Where holding companies are at the head of groups that include separately incorporated banks operating in different countries, the authorities responsible for supervising those banks should endeavor to coordinate their supervision of those banks, taking account of the overall structure of the group in question. Where a bank is the parent company of a group that contains intermediate holding companies, the parent authorities should make sure that such holding companies and their subsidiaries are covered by adequate supervision. Alternatively, the parent authority should not allow the parent bank to operate such intermediate holding companies.Where groups contain both banks and non-bank organizations, there should, where possible, be liaison between the banking supervisory authorities and any authorities which have responsibilities for supervising these non-banking organizations, particularly where the non-banking activities are of a financial character. Banking supervisors, in their overall supervision of banking groups, should take account of these groups' non-banking activities; and if these activities cannot be adequately supervised, banking supervisory should aim at minimizing the risks to the banking business from the non-banking activities of such groups.

Id. at 51.

sion of which is stated to be a joint responsibility of parent and host authorities.[147]

V. THE APPLICATION OF ARTICLE VIII SECTION 2(B) OF THE ARTICLES OF AGREEMENT OF THE INTERNATIONAL MONETARY FUND

Background of the Provision

Article VIII section 2(b) of the Articles of Agreement of the International Monetary Fund (Fund Agreement) has been the subject of continuing comment both by legal writers[148] and by many courts throughout the world. This article provides:

> 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, provided that such measures and regulations are consistent with this Agreement.[149]

Before the Fund Agreement took effect, there was reluctance by the courts of one country to apply the foreign exchange controls of another country. This was the case even though the controls might be found to be part of the governing law according to the private international law of the forum. Sometimes exchange controls were referred to as "revenue," "penal," or simply against the public policy of the forum. Although the rationale differed, the result was often the same: disregard by the forum of the exchange controls of other nations.[150]

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[147] *Id.* at 50-52.

[148] For an analysis of this subject, reference should be made to the writings of the former General Counsel of the Fund, Sir Joseph Gold. *See, e.g.*, J. GOLD, THE FUND AGREEMENT IN THE COURTS (1962 and Supplements); J. GOLD, THE INTERNATIONAL MONETARY FUND AND PRIVATE BUSINESS TRANSACTIONS (1965); J. GOLD, THE CUBAN INSURANCE CASES AND THE ARTICLES OF THE FUND (1966).

[149] Articles of Agreement of the International Monetary Fund, July 22, 1944 (amended effective July 28, 1969), art. VIII, § 2(b).

[150] F. MANN, THE LEGAL ASPECTS OF MONEY (4th ed. 1982).

> It has frequently been said that the private international law of exchange control is, or ought to be, dominated by the principle that exchange control regulations are incapable of international recognition. Although other alleged doctrines such as the public law character or the 'territorialité' of monetary law have been invoked in support of this solution, primarily and in essence it is public policy that is said to require it.

Id. at 401-02.

One of the stated purposes of the Fund in article I of the Fund Agreement is to assist in the termination of restrictions in foreign exchange regulations which impair international trade.[151] The Agreement, however, also recognizes that it might be necessary for a member to retain or impose exchange controls for a time after that member joined the Fund and even thereafter during intervals of stress.[152] This is the rationale of article VIII section 2(b).

In order to clarify certain complexities of the provision, the Fund's Board of Executive Directors issued an interpretation on June 10, 1949.[153] This interpretation sets out the principle that if the exchange controls of a member country are consistent with the Fund Agreement, then exchange contracts involving the currency of that member contrary to its controls should be unenforceable in the courts and administrative bodies of all Fund members.[154] This interpretation noted that the affected contracts should "be treated as unenforceable notwithstanding that under the private international law of the forum, the law under which the foreign exchange control regulations are maintained or imposed is not the law which governs the exchange contract or its performance."[155] Accordingly, the provision establishes a rule which requires recognition of the exchange control of a member country whose currency is involved whether or not the law of such member country is the governing law in accordance with the conflict of laws rules of the forum.[156] On the other hand, article VIII section 2(b) does not abrogate the choice of laws rules of member countries. The provision merely declares that a contract is unenforceable if it is contrary to regulations which are consistent with the Fund Agreement.[157] It does not require enforceability of contracts if the regulations are inconsistent. Accordingly, a member country may apply the foreign exchange controls of another member, as a consequence of the forum's conflict of laws, even though this result is not required by article VIII section 2(b) because the conditions of the latter are not fulfilled.

Article VIII section 2(b) does not require the courts and admin-

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[151] Articles of Agreement of the International Monetary Fund, *supra* note 149, art. I.

[152] *Id.* art. VIII, § 2(b).

[153] International Monetary Fund, Doc. No. 446-4 (June 10, 1949).

[154] *Id.*

[155] *Id.*

[156] Articles of Agreement of the International Monetary Fund, *supra* note 149, art. VIII, § 2(b).

[157] *Id.*

istrative bodies of a Fund member to treat contracts as unenforceable which violate the exchange controls of nonmember countries. It follows as a corollary that the benefits of article VIII section 2(b) no longer are available to a country once it withdraws from the Fund, even with respect to contracts made when the country enjoyed membership.[158] Furthermore, if an exchange contract was originally contrary to the exchange control regulations at the time entered into, but subsequently the regulations are changed so that the contract is not contrary to them at the time of suit, the contract is not unenforceable as a consequence of article VIII section 2(b). By the same token, a contract not contrary to exchange regulations when made may become unenforceable by virtue of the modification or introduction of exchange regulations prior to the time of suit. In a similar manner, changes in the consistency of the exchange regulations with the Fund Agreement may affect the enforceability of a contract. The question of enforceability may depend on changes in the circumstances of the contracting parties. Thus exchange regulations may cease to apply to a party who was a resident of the member country maintaining the regulations at the inception of the contract but who changes his residence thereafter. In such a case, a contract originally unenforceable by virtue of article VIII section 2(b) would no longer be unenforceable. Conversely, the change of status of a party from nonresident to resident of a member country may require that a contract originally enforceable be unenforceable.

The Definition of "Exchange Contract"

One important condition for recognizing the foreign exchange controls of another Fund member is that the member's currency be "involved."[159] Despite varying court interpretations, it has been contended that the better meaning of this word is that "[t]he currency 'involved' is the currency of the member in which there is an effect on the balance of payments or on exchange resources."[160]

Equally crucial to recognizing the foreign exchange controls of a Fund member is the definition of "exchange contract." Sir Joseph Gold has noted that five basic types of economic transaction have been distinguished:

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[158] *Id.*

[159] *See* J. GOLD, THE FUND AGREEMENTS IN THE COURTS—X 483-84 (1972).

[160] *Id.*

(a) purchases and sales of goods or services against financial items (the exchange of goods or services for means of payment);

(b) barter (the exchange of goods or services for goods or services);

(c) the exchange of means of payment for other means of payment;

(d) the provision or acquisition of goods or services without requital (e.g., grants-in-kind);

(e) the provision or acquisition of the means of payment without requital (e.g., gifts).

Transactions in any of these categories may enter into the balance of payments or affect the exchange resources of a country. They can affect exchange resources because they represent an addition to or diminution of the assets or liabilities of a country in the sense that ultimately they could increase, reduce, or forgo an increase in the reserves of the monetary authorities of a country. Therefore, "exchange contracts" are not restricted to category (c) above.[161]

While the highest tribunals in France and the Federal Republic of Germany have adopted the view that "exchange contracts are contracts that affect a member's exchange resources . . .,"[162] two recent cases in the courts of New York and the United Kingdom have taken a more restrictive view of the concept.

In *J. Zeevi & Sons, Ltd. v. Grindlays Bank (Uganda) Ltd.*,[163] an Israeli corporation deposited with Grindlays Bank in Uganda local currency to establish a fund upon which plaintiff Zeevi, an Israeli partnership, could draw. Grindlays Bank then issued an irrevocable letter of credit for the same value in United States dollars to be available against clean drafts. The drafts were to be sent to Grindlays Bank in Uganda, and payment would be made in New York by the debit of its account with First National City Bank upon advice from Grindlays Bank that the terms of the credit had been observed. Shortly after the credit was opened, the Bank of Uganda, acting under the authority of the Minister of Finance, notified Grindlays Bank that foreign exchange allocations in favor of Israeli companies should be cancelled. Grindlays Bank thereupon directed First National City Bank to refuse payment under the credit. When the drafts were presented, they were returned unpaid to the

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161 *Id.*

162 *Id.*

163 37 N.Y.2d 220, 371 N.Y.S.2d 892 (1975).

presenting bank.[164] The New York Court of Appeals affirmed the decision in favor of the plaintiffs. In the course of its decision, the court decided that New York law (rather than that of Uganda) should apply since that jurisdiction had the greatest interest in the litigation and since the contacts that define its interests related to the purpose of the law.[165] Although the letter of credit had become unenforceable as a result of subsequent governmental action in Uganda, such action had no effect in New York. The court then rejected the broad interpretation of "exchange contracts" and excluded the letter of credit from the scope of the definition.[166]

Another case involving the meaning of "exchange contract" was decided by the English Court of Appeal in *United City Merchants (Investments) Ltd. v. Royal Bank of Canada.*[167] Like the *Zeevi* case, *United City Merchants* concerned the circumstances surrounding a letter of credit.[168] In *United City Merchants* an English company (Glass Fibres) agreed to sell equipment to manufacture glass fibre to a Peruvian company (Vitro). As a part of the deal,

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[164] *Id.* at 225.

[165] *Id.* at 227. The court stated:

> New York has an overriding and paramount interest in the outcome of this litigation. It is a financial capital of the world, serving as an international clearinghouse and market place for a plethora of international transactions, such as to be so recognized by our decisional law. . . . A vast amount of international letter of credit business is customarily handled by certain New York banks whose facilities and foreign connections are particularly adaptable to this field of operation. . . . The parties, by listing United States dollars as the form of payment, impliedly accepted these facts and set up procedures to implement their trust in our policies.

Id.

[166] *Id.* at 228. The court stated:

> Defendant urges that enforcement of the letter of credit contract would violate the foreign exchange laws of Uganda in disregard of a treaty. Uganda and the United States are signatories to the Bretton Woods Agreement . . . which, in relevant part under Article VIII (§2, subd. [b]), provides: "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." Contrary to defendants' position, the agreement, even when read in its broadest sense, fails to bring the letter of credit within its scope, since said letter of credit is not an exchange contract. In Banco Do Brasil, S.A. v. Israel Commodity Co., 12 N.Y.2d 371, 375-76, 239 N.Y.W.2d 872, 874, 190 N.E.2d 235, 236, this court frowned on an interpretation of said provisions of the Bretton Woods Agreement which "sweeps in all contracts affecting any members' exchange resources" as doing considerable violence to the text of the section.

Id.

[167] [1981] 3 W.L.R. 242.

[168] *See supra* notes 163-166 and accompanying text.

Glass Fibres agreed to double the real purchase price so that Vitro might obtain from the Peruvian authorities additional foreign exchange. The excess foreign exchange, once received in London, was to be siphoned off and deposited to a Miami account of the director of Vitro contrary to Peruvian exchange control regulations. Payment was to be made under a commercial letter of credit issued by a Peruvian bank (Banco Continental) and confirmed by the defendant bank (Royal Bank of Canada) in London. The equipment was shipped but, unknown to the manufacturer, Glass Fibres, it was shipped a day later than was specified in the letter of credit. To cover for this later shipment, loading brokers had fraudulently entered the earlier date and related information on the bill of lading that was required to be presented for payment under the letter of credit. Although the bill of lading thus conformed on its face to the terms of the credit, the fact that it was false as a result of the fraud of the brokers became known to Royal Bank of Canada. When the documents were presented for payment under the credit, Royal Bank of Canada refused to honor them, and suit was brought by the assignee of Glass Fibres on the letter of credit.[169]

The Court of Appeal, affirming the judgment of the lower court, ruled in favor of the defendant, Royal Bank of Canada. Despite the strict general rule that payment must be made under a letter of credit when the documents presented are in order on their face, all three members of the Court agreed that Royal Bank of Canada was entitled to refuse payment since it knew of the fraud in the bill of lading.[170] One member of the Court reasoned that the exception to the duty to pay under a letter of credit made in the case of fraud is due in part to the fact that banks must rely on the shipping documents as collateral security for their advances and that it is vital that such documents not be worthless.[171]

Another defense that had been offered by Royal Bank of Canada was that the application of article VIII section 2(b) of the Fund's Articles of Agreement would prevent recovery by the plaintiff in its suit on the letter of credit. In considering this defense, however, the members of the Court concluded that the letter of credit contract was not an "exchange contract." It merely required the pay-

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[169] [1981] 3 W.L.R. at 247.

[170] *Id.* at 243.

[171] *Id.* at 277. Judge Acker stated that "[i]f the bank knows that a bill of lading has been fraudulently completed by a third party, it must treat that as a nonconforming document in the same way as if it knew that the seller was party to the fraud." *Id.*

ment of dollars against the stipulated documents. This did not fall within the narrow definition of an "exchange contract" as an agreement to exchange one currency for another.[172] Recognizing the autonomy of the letter of credit from the underlying sales contract which the exigencies of international trade have demanded, the members of the Court nevertheless concluded that they had to look at the whole arrangement.[173] Focusing on the sales contract, the Court viewed it as concealing an exchange contract.[174] But for the effect of the fraud on the letter of credit, Griffiths, L.J., would have given judgment in the suit on the credit for the cost of the machinery and freight but refused judgment for the excess dollars bound for Miami. In any event, the members of the Court agreed that if the suit had been brought on the contract of sale instead of the letter of credit, the plaintiff might have recovered that part of the transaction which represented the genuine price of the equipment sold even though the application of article VIII section 2(b) would have barred recovery of the amount that represented a monetary transaction in disguise.[175]

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[172] *Id.* at 251. Stephenson, L.J., said that "[i]f the letter of credit contract between Glass Fibres and the defendants is considered in isolation, it is a contract to pay dollars against documents. It contains no agreement to exchange one currency for another. And that is what an 'exchange contract' is." *Id.*

Griffiths, L.J., expressly agreed that, viewed in isolation from the contract of sale between Vitro and Glass Fibres, the letter of credit was not an exchange contract. "If it is right to look at the letter of credit in isolation from the matrix of the arrangement in which it operated, I accept that it is not an exchange contract for it did not involve Peruvian currency but was concerned solely with dollars." *Id.* at 279.

[173] *Id.* at 280. In the words of Griffiths, L.J., "[u]nless constrained by authority to do otherwise the court, in my view, ought to look at the whole arrangement and if it sees that the sale contract disguises an exchange contract it should refuse to enforce it through the medium of the letter of credit." *Id.*

[174] *Id.* at 251-52. Stephenson, L.J., continued:

> True it is that the first contract between Glass Fibres and Vitro is a contract of sale and purchase of goods, but that contract itself contains two terms which betray the wolf of an unenforceable exchange contract in the sheep's clothing of an enforceable sale contract: the doubling of the genuine purchase price and the payment of half the doubled price to Nanke in the United States of America. These terms, the overpayment and the disposition of the surplus, are contrary to the exchange control regulations of Peru, and those regulations are admittedly maintained or imposed consistently with the Bretton Woods Agreement. Those terms therefore make the sale agreement a monetary transaction in disguise, at least in part.

Id.

[175] Thus, Ackner, J., said:

> The monetary transaction in disguise being clearly identifiable, I can see no problem in the court refusing to enforce the merchandise contract to the extent that it was an exchange contract. Accordingly, if the plaintiffs had sued upon the mer-

VI. CONCLUSION

This Article demonstrates how jealously the letter of credit obligation has been guarded over the years in the courts so as to protect international trade. The parties to letters of credit rely on their knowledge that the banks must make payments under them in accordance with their terms. The banks must not be concerned with the underlying transactions, but only with the credits themselves. An exception to the rigidity of the rules is recognized, but it has been limited as in *Sztejn* to cases of fraud. The fraud must be palpable and not merely a vague allegation as in *American Bell*, although the exact boundaries have not yet been delimited as is shown by the *Itek* litigation. *Trendtex*, *Texas Trading*, and the related cases show that failure to carry out obligations under a letter of credit will lead to liability even for governments and their central banks. Despite their possible implication in certain bank failures such as that of United States National Bank in San Diego, letters of credit and the financial obligations incurred under them will be protected in the courts. As far as possible, the letter of credit mechanism is also to be preserved from the vagaries of international conflicts. As evidenced by *First National Bank of Boston*, the expropriation of foreign branches and the consequent inability of a parent bank to recover amounts paid under letters of credit may occasion financial loss but will not interfere with the efficacy of the instrument.

Will the protection of the letter of credit given by the courts go so far as to exclude them, by way of interpretation, even from the provisions of an international agreement? Not only has this question arisen in the context of *Itek* and the other Iranian-United States cases where it awaits a decision of the Claims Tribunal, it has arisen in *Zeevi* and *United City Merchants* in a completely different context.

Both *Zeevi* and *United City Merchants* illustrate the difficult problems the courts face in reconciling the demands of international trade with obligations undertaken in accordance with an international agreement. In both cases, the courts expressly recognized the immense importance of protecting a mechanism the purpose of which is to assure payment in commerce between the

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> chandise contract, they would have been entitled to recover so much of the true and genuine price of the goods as was then due and owing.

Id. at 272.

nations. In both cases the courts took a restrictive view of the definition of an exchange contract and in so doing, by judicial interpretation, excluded the letter of credit from the definition thus adopted. In *Zeevi* the court concluded its deliberations once it was able to exclude the letter of credit from the definition. By so doing, it excluded the letter of credit from an obligation undertaken in accordance with an international agreement. In *United City Merchants*, however, through *obiter dicta* the Court may have foreshadowed a further development in the balance that has thus far been effected between the competing considerations. In the words of Stephenson, L.J.:

> International trade requires the enforcement of letters of credit but international comity requires the enforcement of the Bretton Woods Agreement.
>
> I do not see why a court should shut its eyes to the object of the contract and with its eyes shut fall over backwards to avoid complying with the demands of international comity. On the contrary, the courts of this country should incline the other way and do their best to prevent breaches of the Bretton Woods Agreement to which this country is a party. . . .[176]

[176] *Id.* at 258.