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ARTICLES

SOVEREIGN DEBT RESOLUTION THROUGH THE INTERNATIONAL MONETARY FUND: AN ALTERNATIVE TO THE *ALLIED BANK* DECISION

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INTRODUCTION

On April 23, 1984, the United States Court of Appeals for the Second Circuit rendered its first decision in the case of *Allied Bank International v. Banco Credito Agricola de Cartago* (*Allied Bank I*).[1] In *Allied Bank I*, the court held that exchange restrictions imposed by Costa Rica, which prevented certain Costa Rican banks from making payments to foreign creditors in United States dollars when due, would be given effect in United States courts on grounds of comity, because they were consistent with the policy and law of the United States.[2] Accordingly, the court affirmed the lower court's dismissal of an action for breach of payment brought by a syndicate of foreign creditor banks against the Costa Rican debtors.[3] On July 3, 1984, the Second Circuit granted the plaintiff's peti-

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1. 733 F.2d 23 (2d Cir. 1984). Although the decision was subsequently withdrawn by the court, *see infra* note 4 and accompanying text, it will be necessary to cite to the opinion repeatedly in the course of this article, as several important aspects of the case were discussed by the Second Circuit in its first decision (*Allied Bank I*), but *not* in its second decision (*Allied Bank II, see infra* note 5 and accompanying text).

2. 733 F.2d at 24.

3. Id. at 27. The banking industry reacted in shock to this holding. The New York Clearing House Association (the Clearing House), an association of twelve leading commercial banks in New York City, which had already filed an *amicus curiae* brief on the initial hearing on appeal, filed a brief as *amicus curiae* in support of plaintiff's petition for rehearing. The United States government who had not participated in any prior proceedings in the case, also filed a brief as *amicus curiae* in support of the petition.

tion for rehearing.[4] On March 18, 1985, the Second Circuit reversed and vacated its *Allied Bank I* decision. Therefore, the lower court's dismissal of the action was reversed and remanded to the district court for entry of summary judgment for the only plaintiff creditor bank left on appeal.[5] In *Allied Bank II*, the court held that in *Allied Bank I* it had mistakenly found the Costa Rican restrictions consistent with United States policy and therefore, such restrictions were not entitled to recognition on grounds of comity.[6] The court also held that the act of state doctrine did not prevent the United States courts from rendering a judgment in the case, because the situs of the debt was in the United States and not in Costa Rica.[7]

The *Allied Bank* litigation sent shock waves through the money centers of the globe and the capitals of overburdened debtor countries. This paper is not, however, a case comment on *Allied Bank*. The purpose of this paper is to suggest ways to prevent litigation in situations analogous to the one involved in *Allied Bank*. This kind of litigation, regardless of the outcome and the reasoning offered to justify it, has a devastating impact on the precarious equilibrium laboriously achieved day after day in the international debt arena. It is too dangerous and disruptive for all parties involved—winners and losers alike—to surrender their fate to the hands of tribunals, who are forced to decide complex issues in a piecemeal, case-by-case fashion.Therefore, a systemic and institutional alternative to litigation must be developed to avoid such consequences.

This thesis is true regardless of the ultimate outcome in *Allied Bank*, because the case lacks any credible effort to analyze the systemic and institutional concern raised by the situation at issue. The *Allied Bank II* court confined itself to a recitation of the language used by the United States government, as *amicus curiae*, to support a vaguely defined and superficially analyzed "debt resolution procedure that operates through the auspices of the IMF."[8] The court, however, refused to discuss and construe the actual provisions of the International Monetary Fund Articles of Agreement (the Bretton Woods Agreement). In fact, any reference to the Agreement, or the "charter" of the international monetary order, was omitted from the *Allied Bank* decisions.[9] Therefore, in a way *Allied*

4. The Second Circuit granted a rehearing before the same panel that had heard the case in the first instance. Both the Clearing House and the United States government filed *amicus curiae* briefs in support of plaintiff on rehearings. For a discussion of some of the arguments raised by *amici* on rehearing, *see infra* notes 135-145 and accompanying text.

5. Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985). This second decision of the Second Circuit will hereinafter be referred to as *Allied Bank II*.

6. *Id.* at 519-20.

7. *Id.* at 523.

8. *Id.* at 519. *See infra* notes 39-42, 135-138 and accompanying text.

9. The IMF Agreement was only mentioned briefly in the Brief for Defendants-Appellees on Rehearing at 40-41, Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985) [hereinafter cited as Defendant's Brief], where defendants sug-

Bank epitomizes the inability, or the unwillingness, of the judicial process to accommodate any systemic and institutional consideration for the purposes of resolving the international debt crisis.

Institutional and systemic considerations are, however, the most important issues for the future and will be the exclusive focus of this essay. Looking ahead to possible future instances where debtor countries resort to exchange controls to handle their external debt crisis, a number of lessons must be drawn from *Allied Bank.* This paper submits that the Bretton Woods Agreement contains the means and authority for the Fund to play a central role in a situation similar to the one at issue in *Allied Bank* and to offer a viable alternative to future litigation.

I. THE ALLIED BANK LITIGATION

Allied Bank International (Allied) brought an action in the United States District Court for the Southern District of New York, on behalf of thirty-nine United States and foreign creditor banks, against three Costa Rican banks, which are owned by the Republic of Costa Rica. The action was brought for breach of payment of certain notes issued by the Costa Rican banks in 1976.[10] Payments on the notes were to be made in New York with United States dollars.[11] The loan agreements provided for concurrent jurisdiction in the New York and Costa Rican courts.[12] The dollars were to be supplied by the Costa Rican Central Bank.[13] The loan agreements also provided that a failure to make a payment due solely to the omission or refusal of the Central Bank to provide the necessary U.S. dollars would not constitute an event of default for a ten day grace pe-

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gested a possible analogy between the situation covered by Article VIII, section 2(b) of the Fund Agreement and the facts of *Allied Bank*:

> The precise scope of the Bretton Woods Agreement and its applicability to loan agreements such as that in question [in *Allied Bank*] has never been addressed by a federal appellate court, and other authorities are in conflict. However, regardless of how various clauses of Bretton Woods ultimately are interpreted, its thrust is clear: the United States recognizes, and has agreed to respect, exchange control by foreign nations for legitimate purposes.

Id. at 41.

The Clearing House responded to this argument, Reply Brief of the New York Clearing House Association as *Amicus Curiae* on Rehearing at 9-13, Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985)[hereinafter cited as Clearing House Reply Brief]. *Amicus* argued that the loans at issue in *Allied Bank* were not "exchange contracts" within the meaning of Article VIII, section 2(b). *Id.* at 10. *Amicus* also claimed that "even assuming that an international loan agreement were an exchange contract, there is no U.S. authority holding that such a loan agreement, enforceable when made, may be rendered unenforceable by an intervening exchange regulation." *Id.* at 12. Finally, *amicus* argued that in any event the Costa Rican exchange controls were not "maintained or imposed consistently with [the Bretton Woods] Agreement." *Id.* at 13.

10. *Allied Bank II*, 757 F.2d at 518.

11. *Id.* at 519.

12. *Id.*

13. *Id.*

riod.[14] After such period, however, the creditors could demand full payment of the promissory notes.[15]

Payments were regularly made until August 1981, when the government of Costa Rica, in response to a severe economic crisis, unilaterally halted the release of any currency for the payment of debts.[16] In November 1981, the government of Costa Rica in effect utilized controls over foreign exchange to establish a temporary suspension of payments on external debts, unless the prior approval of the Central Bank was obtained.[17] The Central Bank did not authorize payments of principal and interest on the promissory notes at issue.[18] The Costa Rican government's decree, deferring payments on the foreign debt, stated that "presently the government of Costa Rica is renegotiating its external debt and for this purpose there should be harmony of decisions and centralization in the decision-making process."[19] All the foreign creditor banks brought an action in the New York District Court for breach of payment on the notes.[20] While this action was pending, the banks began negotiations for the rescheduling of the debt.[21] In July 1983, the U.S. District Court for the Southern District of New York dismissed the action on the ground that the act of state doctrine applied to the acts of the Costa Rican government.[22] In September 1983, an agreement rescheduling the Costa Rican debt was signed by all the creditor banks except one, Fidelity Union Trust company of New Jersey (Fidelity).[23] On appeal from the District Court's dismissal, Allied represented the lone bank which continued to refuse to accept the rescheduling.[24]

Costa Rica's deferment of payments on foreign debts also caused it to default on its intergovernmental obligations.[25] Such default triggered section 620(a) of the Foreign Assistance Act,[26] which prohibits governmental aid to any country in default on loan payments to the United States, un-

14. *Allied Bank I*, 733 F.2d at 24.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.* at 25.

19. *Id.* at 24-25. Throughout the litigation defendants argued that this reason for the deferment indicated that Costa Rica never intended to repudiate its external debt. Defendants saw this good faith defense as the central aspect of the case and argued that "nothing in the [*Allied Bank*] decision, or the arguments of the Costa Rican banks, may be read to permit a foreign country unilaterally to abrogate its debts to U.S. citizens." Defendants' Brief on Rehearing at 2. The defendants thus tried to limit the holding to the specified facts of the case and reprimanded the plaintiff and *amici* for their "desire to foreclose an undesired result in a different case in another court at a future time." *Id.*

20. *Allied Bank I*, 733 F.2d at 25.

21. *Id.*

22. 566 F. Supp. 1440 (S.D.N.Y. 1983).

23. *Allied Bank I*, 733 F.2d at 25.

24. *Id.*

25. *Id.*

26. Pub. L. No. 87-195, 75 Stat. 424 (1961) (codified as amended in scattered sections of 22 U.S.C.).

less the President advises Congress that "assistance to such country is in the national interest."[27] Both President Reagan and the House of Representatives expressed full support for Costa Rica.[28] In January 1983, the United States joined several other nations in the signing of the Paris Club Agreed Minute which rescheduled the intergovernmental debt of Costa Rica.[29]

The court in *Allied Bank I* held that the actions of the Costa Rican government causing default on the notes were "consistent with the policy and law of the United States" and that comity required that such actions be given effect in the United States courts.[30] The court did not rule on the act of state defense relied upon by the District Court below.[31] The Court of Appeals also stated that the result it reached was not dependent on the choice of the controlling law as determined by the situs of the debt.[32]

In its finding that the Costa Rican decree was consistent with the policy and the law of the United States, the court in *Allied Bank I* relied in part on the support for Costa Rica manifested by both the legislative and the executive branches of the United States government.[33] More importantly, however, the court drew an analogy between Costa Rica's prohibition of payment of its external debt and the reorganization of a business pursuant to Chapter 11 of the U.S. Bankruptcy Code.[34] The court reasoned that Costa Rica's actions were not a repudiation of the debt, but rather a mere "deferral of payments while it attempted in good faith to renegotiate its obligations."[35] Giving effect in the United States courts to the Costa Rican exchange restrictions, the court concluded, would achieve the same result as an automatic stay of all collection actions against a business filing an application for reorganization under Chapter 11.[36]

The same court, however, changed its conclusions and held in *Allied Bank II* that, in light of the U.S. government's "elucidation of its position," the court was no longer convinced that the Costa Rican decree was consistent with the policy of the United States.[37] The *Allied Bank II* court made no mention of its prior analogy of a debtor country rescheduling its debt and a domestic debtor filing for reorganization under Chapter

27. 22 U.S.C. section 2370 (g)(1982).
28. *Allied Bank I*, 733 F.2d at 25.
29. *Id.*
30. *Id.* at 24.
31. *Id.*
32. *Id.*
33. *Id.* at 26.
34. *Id.*
35. *Id.*
36. *Id.*
37. *Allied Bank II*, 757 F.2d at 520. The court concluded that the Costa Rican government's unilateral attempt to repudiate private commercial obligations was inconsistent with the orderly resolution of international debt problems and with the interests of the United States as a major source of private international credit. *Id.* at 522.

11.[38] The court changed its opinion on the *Allied Bank* situation because it was fully persuaded by the U.S. Justice Department's claimed support for "the debt resolution procedure that operates through the auspices of the IMF," since "guided by the IMF, this long established approach encourages the cooperative adjustment of international debt problems."[39] The *Allied Bank II* court reasoned that such a procedure required that the underlying obligations to pay remained valid and enforceable.[40] Therefore, the court concluded, Costa Rica's attempted unilateral restructuring of private obligations threatened the system of international cooperation and negotiation supported by the United States, and thus was inconsistent with United States policy.[41] The court did not question the United States government's explanation of its apparently inconsistent position, which on the one hand opposed Costa Rica's conduct insofar as private international debts were concérned, while at the same time, officially supported that same conduct insofar as intergovernmental obligations are concerned.[42]

According to the *Allied Bank II* court, Costa Rica's exchange restrictions could not be respected in the United States courts on grounds of comity. Consequently, the court had to rule on the act of state defense raised by the defendant debtors below.[43] The court noted that if, as the court below had held, the act of state doctrine was applicable, judicial examination of the Costa Rican decree would be precluded. The court, however, concluded that the act of state doctrine was inapplicable to the facts of *Allied Bank*.[44]

The *Allied Bank II* court reasoned that the act of state doctrine did not bar inquiry by the courts into the validity of extraterritorial takings.[45] According to the court, the act of state defense would have been available if the situs of the property, the debt, was in Costa Rica at the time of the

38. The court simply said, rather cryptically, that "the appellees' ability to pay United States dollars relates only to the potential enforceability of the judgment; it does not determine whether judgment should enter." *Id.* at 522.

39. *Id.* at 519.

40. *Id.*

41. *Id.*

42. *Id.* The court explained that its holding in *Allied Bank I* was premised on the United States' willingness to restructure Costa Rica's intergovernmental loans and to continue providing aid to Costa Rica. *Id.* at 520.

43. *Id.* at 520.

44. *Id.* The court explained that the act of state doctrine operates to confer presumptive validity to certain acts of foreign sovereigns by rendering nonjusticiable claims that challenge such acts. *Id.* Quoting from the U.S. Supreme Court's opinion in Underhill v. Hernandez, 168 U.S. 250, 252 (1897), the court said that "every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit judgment on the acts of the government of another done within its own territory." *Id.*

45. *Id.* at 520. Quoting from Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 427 (1964), the court stated that the act of state doctrine protects only the validity of a taking of property by a foreign government within its own territory. *Allied Bank II*, 757 F.2d at 520.

purported taking.[46] However under ordinary situs analysis, the court found that the loan agreement's nexus with New York,[47] as well as the United States' "interest in maintaining New York's status as one of the foremost commercial centers in the world,"[48] made New York the situs of the debt.[49] Accordingly, the court concluded the Costa Rican decree was an extraterritorial taking of property and as such, was unprotected by the act of state doctrine.[50]

II. APPLICABILITY OF ARTICLE VIII, SECTION 2(B) TO THE ALLIED BANK DISPUTE

The application of the Bretton Woods Agreement to the dispute was never before the *Allied Bank* court. It is, however, appropriate to address this issue because both Costa Rica and the United States are members of the IMF. The situation at issue in *Allied Bank* is at least arguably covered by Article VIII, section 2(b) of the Fund Agreement[51], which provides, in part, that "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 [the Fund] Agreement shall be unenforceable in the territories of any member." In its interpretation of this provision,[52] the Fund stated that the purpose of Article VIII, section 2(b) is to withdraw from private parties, who violate the legitimate exchange regulations of a member, "the assistance of the judicial or administrative authorities of other members in obtaining the performance of such contracts."[53] In the same decision, the Fund made it clear that "by accepting the Fund Agreement members have undertaken to make the principle mentioned above effectively part of their national law."[54]

The United States has accepted the Fund Agreement, and therefore,

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46. *Id.*

47. *Id.* The court noted that: the debtors conceded jurisdiction in New York; payments were to be made in New York; Allied, the syndicate agent, is located in New York; and some of the negotiations between the parties took place in the United States. *Id.*

48. *Id.* The court noted that the viability of New York as an international clearing center for United States dollars and the source of billions of dollars of international loans each year depends on creditors' confidence in the judicial enforceability of contracts subject to the jurisdiction of the United States courts. *Id.* at 521-22.

49. *Id.* at 522.

50. The court offered a secondary reason for its conclusion, namely that the purported taking had not "come to complete fruition within the dominion of the foreign government" since Costa Rica could not wholly extinguish the debtor banks' obligations to pay United States dollars to Allied in New York. *Id.* at 521.

51. *See infra* text accompanying notes 60-69.

52. Pursuant to Article XXIX(a) (formerly Article XVIII) of the Fund Agreement, the Executive Board of the Fund has the authority to settle with finality any question of interpretation of the Articles that arises between a member and the IMF or between members.

53. IMF DECISION NO. 446-4, SELECTED DECISIONS OF THE INTERNATIONAL MONETARY FUND AND SELECTED DOCUMENTS 233 (1983) [hereinafter cited as SELECTED DECISIONS].

54. *Id.* at 233-34.

has given Article VIII the force of law in the United States.[55] If it can be demonstrated that Article VIII, section 2(b) does indeed apply to loan agreements of the kind at issue in *Allied Bank*, the courts of the United States have a duty to apply the positive law of the IMF Agreement in the same manner as a treaty.

Assuming that Article VIII, section 2(b) applies to such loan agreements,[56] the crucial inquiry in *Allied Bank* should have been whether the Costa Rican exchange restrictions were maintained or imposed consistent with the law and policy of the United States. The Second Circuit should have denied recognition to the Costa Rican decree, unless sufficient evidence had been introduced to satisfy the court that the promissory notes at issue were unenforceable since the requirements for claiming the Article VIII, section 2(b) defense were satisfied. If the Secound Circuit had given or denied effect to the Costa Rican decree based solely on the unilateral interest of the United States , it would have violated the spirit and the letter of the Fund Agreement, which is an integral part of the law of the United States.

A future role of the Fund in similar circumstances surpasses the effect that an application of Article VIII, section 2(b) would have had in *Allied Bank*. Even if the Second Circuit had considered Article VIII, section 2(b) as the governing rule of the case, the outcome would have simply been determined by considering which party had the burden of proving that the requirements of such provision were satisfied and whether sufficient evidence could have been offered to meet the burden. In such circumstances, the Fund's role would have been a reactive one, albeit a crucial one in the litigation. Pursuant to the Fund's undertaking "to lend its assistance in connection with any problem which may arise in relation to the. . .interpretation of. . .Article VIII, section 2(b),"[57] the Fund would have had jurisdiction to make a conclusive determination that the exchange control regulations were, or were not, maintained or imposed consistently with the Articles.[58]

A more crucial lesson to be learned from *Allied Bank*, however, is that Article VIII, section 2(b) may present the Fund with the opportunity to play an active role in future situations where a debtor country facing a liquidity crisis chooses to impose restrictive exchange controls, which make it impossible for domestic borrowers to honor their obligations to foreign lenders when due. The Fund's active role should ideally prevent litigation, rather than determine its outcome. The remainder of this paper will explore exactly what such role should be and how it can be reconciled with the Bretton Woods Agreement, from which the Fund derives its authority.

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55. 22 U.S.C. section 286 (1982).
56. *See infra* notes 60-64 and accompanying text.
57. IMF DECISION NO. 446-4, SELECTED DECISIONS, *supra* note 53, at 234.
58. *Id.*

III. ARTICLE VIII, SECTION 2 CONDITIONALITY

The question whether international loan agreements[59] are included in the definition of "exchange contracts" for purposes of Article VIII, section 2(b) has not yet been resolved. In the last four decades two different definitions of exchange contracts have been proposed: a narrow one, restricted to contracts for the exchange of currency of one country for that of another or at the most, to contracts which are "monetary transactions in disguise,"[60] and a broad one, encompassing all contracts that in any way affect a country's exchange resources.[61] The narrow definition, contrary to the broad one, excludes a promise between residents of different countries to lend or deposit an amount in foreign currency against a promise by the debtor to pay interest on and to repay or return such

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59. Such loans normally involve the extension of credit in a particular currency in exchange for a promissory note obligating the debtor to pay interest and, in accordance with a maturity schedule, to repay the principal of the loan in the same currency. *See generally*, R. W. EDWARDS, JR., INTERNATIONAL MONETARY COLLABORATION 129-32 (publication forthcoming).

60. This definition was originally proposed by Professor Arthur Nussbaum, *Exchange Control and the International Monetary Fund*, 59 YALE L.J. 421, 426-26 (1949). Such definition was approved by the House of Lords in Wilson, Smithett & Cope, LTD. v. Terruzzi, [1976] 1 Q.B. 683, 709 (C.A.) (Kerr J.), 709 (CA), and in United Merchants (Investments) Ltd. et al. v. Royal Bank of Canada et al., [1982] 2 W.L.R. 1039. The New York Courts have also followed this definition in Banco de Brasil v. Israel Commodity Co., Inc., 12 N.Y.2d 371, 239 N.Y.S.2d 872, 190 N.E.2d 235 (1963), *cert. denied*, 376 U.S. 906 (1964); J. Zeevi & Sons, Ltd. v. Grinlays Bank (Uganda) Lts., 37 N.Y.2d 220, 371 N.Y.S.2d 892, 333 N.E.2d 168 (1975). *See generally*, Gold, *"Exchange Contracts," Exchange Control, and the IMF Articles of Agreement: Some Animadversions on Wilson, Smithett & Cope Ltd. v. Terruzzi*, 33 INT'L & COMP. L.Q. 777 (1984) [hereinafter cited as Gold, *Exchange Contracts*]; F.A. MANN, THE LEGAL ASPECTS OF MONEY 385-91 (4th ed., 1982) [hereinafter cited as MANN, LEGAL ASPECTS OF MONEY].

61. This definition has received the vigorous support of Sir Joseph Gold, Gold, *Exchange Contracts*, *supra* note 60, at 787-89; of Dr. Mann, MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 387-88; of Elias Krispis, Krispis, *Money in Private International Law*, **120** RECUEIL DES COURS 191, 286-90 (1967); of John Williams, Williams, *Extraterritorial Enforcement of Exchange Control Regulations Under the International Monetary Fund Agreement*, 15 VA. J. INT'L L. 319, 332-44 (1975); and of Prof. Francois Gianviti, Gianviti, *Le Controle des Changes Etrangers Devant le Juge National*, 69 R.C.D.I.P. 667, 674 (1980). The broad view of exchange contracts has been adopted by courts in a number of countries, including Germany and France. For a detailed discussion of such cases *see* MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 386-87. *See generally* J. GOLD, THE FUND AGREEMENT IN THE COURTS (1962) [hereinafter cited as GOLD, FAIC] and J. GOLD, THE FUND AGREEMENT IN THE COURTS: VOLUME II (1982) [hereinafter cited as GOLD, FAIC II]. *See also* Gold, *The Fund Agreement in the Courts*, in IMF STAFF PAPERS 199 (1983). A review of scholarly comments and court decisions in all IMF members led Dr. Mann to conclude that the majority of learned writers would seem to support the broad view. MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 389. Sir Joseph Gold also stated that most of the cases cited by the *Terruzzi* court in support of the narrow view were lower court decisions, contrary to the decisions supporting the broad view rendered by the highest German and French courts. Gold, *Exchange Contracts*, *supra* note 60, at 798. Considering the relative reputation and status of the courts that have confronted the issue, Sir Joseph Gold concluded that "the tilt would be towards the broad interpretation." *Id.*

principal amount, either in the same currency or in the debtor's own currency.[62]

In a recent article, Sir Joseph Gold convincingly criticized the narrow view of exchange contracts.[63] He also delivered a very compelling argument in favor of the broad view, stating that "good sense, the purposes of the Articles, and the history of Article VIII, section 2(b)" support such a view.[64] If Gold's analysis is sound, the definition of exchange contracts in Article VIII, section 2(b) includes loan agreements between borrowers in the country imposing exchange control regulations and foreign lenders, regardless of the currency in which payments of interest and principal are to be made and regardless of whether the borrower already has the foreign currency needed to make such payments or has to contract to purchase it.

Assuming that Article VIII, section 2(b) is applicable to international loan agreements, the concept of Fund conditionality should be extended to the availability of a Bretton Woods defense. This proposal is premised

62. Sir Joseph Gold noted some apparently odd consequences that this conclusion would have in the international lending situation and relied on such oddities to criticize the narrow view of exchange contracts. Gold, *Exchange Contracts*, *supra* note 60, at 786, 791. In particular, Gold noted that while such definition would exclude loans to be repaid in the *same* currency, it would not exclude the same loans if they had to be repaid in a different currency. *Id.* at 786. He concluded that the drafters of Article VIII, section 2(b) could not possibly have intended to make such a distinction. *Id.* Sir Joseph Gold also noted that, even if a particular loan agreement were covered by the narrow definition of exchange contracts, the operation of Article VIII, section 2(b) would be frustrated if the debtor already had the foreign currency necessary to pay interest or principal to foreign creditors and thus did not have to contract to purchase the foreign exchange. *Id.* at 791. Gold concluded that "no economic justification exists for distinguishing between a payor who already has the necessary exchange to make prohibited payments and a payor who must buy it." *Id.*

63. Gold, *Exchange Contracts*, *supra* note 60, at 787, 793-94, 799-800, 801-02. The author criticized the logic underlying Professor Nussbaum's proposal for a narrow view of exchange contracts, which was adopted by the *Terruzzi* court. *Id.* at 787. Gold also criticized the *Terruzzi* court's interpretation of the text of Article VIII, section 2(b) and of the expression "exchange contracts" in relation to Article VIII, section 2(a) and Article VI, section 3. *Id.* at 793-94, 799-800. Finally, Gold criticized the policy considerations offered by the *Terruzzi* court to support its narrow view of exchange contracts. *Id.* at 801-02.

64. Sir Joseph Gold stated that the narrow view of exchange contracts would "reduce Article VIII, section 2(b) to triviality . . . not only because the category of exchange contracts defined in this way would be so small a proportion of total contracts under which international payments and transfers or capital transfers are made, but also because cases within the limited category would be unlikely to come into the courts." *Id.* at 789. Gold also offered an interpretation of the text of Article VIII, section 2(b) whereby the alleged redundancies in the expressions "exchange contracts" and "involve the currency of any member," as well as in the expressions "exchange contracts" and "exchange control regulations" would be eliminated. *Id.* at 793-94. Such supposed redundancies had become an argument in favor of the narrow view adopted by the *Terruzzi* court, following a comment made by Dr. Mann, MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 385. *See Terruzzi*, [1976] 1 Q.B. 709, 712. Finally, Gold demonstrated that a correct understanding of the interests and purposes of the IMF supports a broad definition of exchange contracts especially after the second amendment of the Articles. Gold, *Exchange Contracts*, *supra* note 64, at 788, 802-05, 808-10.

on the unenforceability of exchange contracts contrary to a member's exchange control regulations, via the "imposed or maintained consistently with [the Fund] Agreement" clause of Article VIII, section 2(b).[65] While conditionality has so far been restricted to the receipt by a member of money from the Fund, there is no reason in law or policy why it should be so limited. This article will suggest that conditionality can reasonably be viewed as a general concept, inherent to the Fund's authority to approve, or disapprove, certain actions by members based on various provisions of the Articles. Therefore, the Fund can invoke conditionality whenever a member seeks to enjoy a privilege consistent with the IMF Agreement.

The unenforceability of exchange contracts which violate the legitimate exchange controls of a member is such a privilege. The Article VIII, section 2(b) privilege can be subjected to Fund conditionality through the authority given to the Fund by various provisions of the Articles. The recognition of exchange control regulations outside the country imposing them is a privilege available to Fund members because of their membership in the IMF.[66] The traditional view of courts in most countries has been that exchange controls, like tax and penal laws, are enforceable only in the territory of the sovereign that issued them.[67] It is a widely accepted principle of international private law that the enforcement of foreign exchange controls outside the country imposing them would be against the public policy of the forum where such enforcement is sought.[68] The view taken by the Second Circuit in *Allied Bank II* is consistent with this ma-

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65. Article VIII, section 2(b) is normally claimed as a defense by a private, and occasionally by a public party to a contract in an action for breach brought by another party before the courts or administrative tribunals of an IMF member country. If the Article VIII, section 2(b) defense is available to the party claiming it, the action for breach of contract must be dismissed, because the underlying contract is "unenforceable in the territories of any member." Whether the defense is in fact available in a given action depends on whether the three requirements of Article VIII, section 2(b) are satisfied. These requirements are: (1) the contract must be an "exchange contract which involves the currency of (a) member;" (2) it must be "contrary to the exchange control regulations of that member;" and, (3) such exchange control regulations must be "maintained or imposed consistently with (the Fund) Agreement." These requirements are cumulative.

It should be apparent that, contrary to the first two requirements, the third requirement has nothing to do with the contract itself or with the conduct of any private parties, but rather concerns the official acts of a member country *vis-a-vis* the Fund and the Articles of Agreement. The Fund made it clear that the third requirement is subject to its regulatory authority: "the Fund is prepared to advise whether particular exchange control regulations are maintained or imposed consistently with the Fund Agreement." IMF DECISION No. 446-4, SELECTED DECISIONS, *supra* note 53, at 234. Through the third prong of the test, therefore, the Fund can determine the availability of the Article VIII, section 2(b) defense to private parties, who are not, as such, directly subject to the Fund's regulatory authority.

66. MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 372.

67. A.F. LOWENFELD, THE INTERNATIONAL MONETARY SYSTEM 323 (2nd ed. 1984).

68. MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 402, 428. For pre-Bretton Woods surveys, see Domke, *Foreign Exchange Restrictions (A Comparative Survey)*, 21 J. COMP. LEGIS. & INT'L L. 54 (1939); Freutel, *Exchange Control, Freezing Orders, and the Conflict of Laws*, 56 HARV. L. REV. 30 (1942).

jority position.[69]

The Article VIII, section 2(b) privilege is particularly valuable for a debtor country facing a deteriorating external debt ratio and the risk of default, since it prevents foreign lenders from enforcing their contract rights in the courts of any other member of the Fund. The concept of conditionality is already available in Article V, section 3, with stand-by arrangements.[70] A stand-by makes available to the debtor sufficient foreign currency to pay debt service and avoid default, at least temporarily.[71] The availability of the Article VIII, section 2(b) defense in enforcement actions brought against borrowers in the debtor country would have the same effect as an automatic stay of all collection actions against a business filing an application for reorganization under Chapter 11 of the U.S. Bankruptcy Code.[72] Since the benefit for a defaulting debtor country is the same under both provisions of the Articles, the costs should also be the same. If a member must subject itself to the burden of Fund conditionality to obtain a stand-by arrangement, it is not unreasonable to suggest that it should face the same burden to enjoy the privilege of Article VIII, section 2(b) protection from external creditors. It is submitted that conditionality should be extended from Article V, section 3 to Article VIII, section 2(b).[73]

69. This issue was extensively belabored in the briefs submitted on rehearing in the *Allied Bank* litigation. It should be noted that the traditional rule against extraterritorial recognition of exchange controls is supported by ample authority in the United States. *See generally* Cent. Hanover Bank & Trust Co. v. Siemens & Halske Aktiengesellshaft, 15 F.Supp. 927 (S.D.N.Y.), *aff'd mem.*, 84 F.2d 993 (2d Cir.), *cert. denied*, 229 U.S. 585 (1936), and its progeny. There is, however, authority to the contrary, both in the United States and in England. *See, e.g.*, Perutz v. Bohemian Discount Bank in Liquidation, 110 N.Y.S.2d 446, 304 N.Y. 533, 110 N.E.2d 6 (1952); Frankman v. Anglo-Prague Credit Bank (London Office)[1948] 1 All E.R. 337; Frankman v. Anglo-Prague Credit Bank [1948] 2 All E.R. 1025; Zivnostenska Banka National Corporation v. Frankman [1949] 2 All E.R. 671; Kahler v. Midland Bank, Ltd. [1948] 1 All E.R. 811; 2 All E.R. 621. All these cases are discussed in detail in GOLD, FAIC, *supra* note 61, at 28-30, 50-55, 75-76, 78-79, 134-39; 16-17; 18-19, respectively.

70. For a complete discussion of Articles V (3) and VIII (2)(b) of the Fund Agreement *see generally* A.F. LOWENFELD, *supra* note 67, at 32-42, 323-349, 366-376. In the same book, Lowenfeld presents several illustrations of how the Fund Agreement and the IMF operate in an international monetary crisis.

71. It has been said that a member "buys a reasonable amount of time as well as foreign exchange" when it resorts to a stand-by arrangement. *Id.*

72. 11 U.S.C. Sections 103(a), 362, 901(a) (1982). This was the core of the now withdrawn decision of the Second Circuit in *Allied Bank I*, 733 F.2d at 26.

73. Throughout this paper it will be assumed that the operation of Article VIII, section 2(b) is unaffected by the time when exchange controls are imposed, relative to the time when an exchange contract is made. The most important consequence of this assumption is that exchange contracts which at the date of their conclusions are consistent with, but during their lives become contrary to, the exchange regulations of a member maintained or imposed consistently with the Fund Agreement are covered by Article VIII, section 2(b). This is not, indeed, a settled proposition. Authoritative commentators and courts hold conflicting opinions on the issue. *See e.g.* MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 377-79; Gold, *The Fund Agreement in the Courts*, in IMF STAFF PAPERS 199, 202, 202 n.60;

Traditional conditionality establishes a link between the Fund's financial assistance to a member with balance of payment difficulties and the adoption by such member of economic adjustment policies (so called "austerity measures"), with the double purpose of correcting the balance of payments disequilibrium and assuring that the revolving nature of the Fund's resources is maintained.[74] The notion of conditionality arose out of the question, left open at Bretton Woods, of whether the resources of the Fund would be made available to members as of right or under conditions set by the Fund.[75] Since the text of the original Agreement was vague enough to support both positions,[76] conditionality developed entirely out of the Fund's practice.[77] Although "Fund conditionality requirements" are now expressly provided for in Article V, section 3, conditionality, as a general category it is capable of further expansion in connection with other aspects of the Fund's activity. As Sir Joseph Gold

GOLD, FAIC, *supra* note 61, at 62-66, 77-78; GOLD, FAIC II, *supra* note 61, at 16-17, 88, 140-43, 150-53, 160, 262, 276-77, 298, 355. The issue of subsequent exchange restrictions under Article VIII, section 2(b) is clearly raised in the circumstances of the *Allied Bank* litigation.

The author of this article concedes without hesitation that this assumption is vital to the thesis of this paper. *See infra* note 120. The author, however, believes that nothing could be accomplished by an extended discussion of the issue here. The issue of subsequent exchange controls is not likely to be resolved once and for all, but must rather be faced by each individual court in each individual case based on precedent in each individual jurisdiction.

74. In general, IMF-sponsored adjustment programs embody monetary and budgetary policies that are consistent with reasonable price stability; exchange rate, interest rate, trade and other policies, aimed at improving efficiency and strengthening the productive base of the economy; and a prudent external debt management policy. Remarks by J. de Larosiere, Managing Director of the IMF, before the Institute of Foreign Bankers in New York (May 2, 1984), *reprinted in* IMF SURV., May 21, 1984. Fund supported programs emphasize a number of major economic variables, such as domestic credit, the financing of the public sector, and external debt, as well as some key elements of the price system, including the exchange rate, the interest rate, and, in some cases, the prices of commodities that bear significantly upon the public finances and foreign trade. *Conditionality*, IMF SURV., September 1984, at 2. The implementation of IMF-sponsored austerity measures is monitored with the help of performance criteria, the choice of which is dictated by the particular conditions of the member country involved. *Id.* The impact of Fund-supported programs on income distribution, employment, and social services, depends on the policies chosen to implement the program. *Id.* at 3. Such choices are left entirely to the government of the member involved. *Id.* Typically, the necessary adjustment efforts are highly unpopular, as they cause a severe restriction in the member's economy. Such unpopularity accounts for most of the problems encountered by the Fund in forcing a member with balance of payments difficulties to commit itself to strong adjustment efforts. The approach of the Fund to economic adjustment and the "mix" of policies typically emphasized by the IMF are the subject of continuous debate among economists. The Fund's continued focus on the control of domestic demand as the primary variable has been the target of much criticism as it may "threaten to be destructive of national prosperity in terms of output, employment, and development. *The IMF's Role in Developing Countries*, FIN. & DEV., September 1984.

75. Lowenfeld, *Is There Law After Bretton Woods?*, 50 U. CHI. L. REV. 380, 385 (1983).

76. *Id.*

77. Sir Joseph Gold wrote that "no part of the development relied on the language in the original Articles that could be deemed to be explicit or beyond controversy." J. GOLD, LEGAL AND INSTITUTIONAL ASPECTS OF THE IMF: SELECTED ESSAYS 54 (1979).

stated in 1978, conditionality is implicit in a number of provisions and the development in the past "illustrates an evolution of fundamental importance that is possible when sufficient leeway is made available by the drafters of the text."[78] Article VIII, section 2(b) indeed affords "sufficient leeway" for the development of a new kind of conditionality.

The legal character of conditionality, as it applies to the Fund's financial assistance, reinforces the conclusion that it need not be restricted to a member's access to the Fund's general resources. Fund conditionality is not the equivalent of a borrower's undertakings in connection with a loan; rather it is a member's "pledge" to use the resources of the Fund in accordance with the obligations under the Agreement and the policies of the Fund.[79] The Articles use terminology appropriate to an exchange transaction in connection with conditionality and never use the language of loans and credits.[80] In other words, the purpose of conditionality is not to ensure the prompt repayment of the upper credit tranches, but rather to ensure that the Fund's resources are used to promote the stability of the international financial system and the prompt correction of disequilibria and distortions.[81]

The extension of conditionality from Article V, section 3, governing access to the general resources of the Fund, to Article VIII, section 2(b), governing the availability of an affirmative defense to collection actions, finds support in the non-contractual character of conditionality, which makes it an appropriate legal instrument in both contexts. A decision of the Fund in 1979,[82] makes clear that "stand-by arrangements are not international agreements and therefore language having a contractual connotation will be avoided in stand-by arrangements and letters of intent."[83] Article XXX(b) defines stand-by arrangements as decisions made by the Fund in response to requests by members to approve a stand-by arrangement.[84] The request is normally accompanied by a letter of intent, setting forth the terms and conditions upon which the member is willing to gain access to the Fund's general resources. The cited decision of the Fund rejected the interpretation of stand-by arrangements as the Fund's acceptance of a member's offer to implement the austerity measures contained in the letter of intent.[85]

If a member's letter of intent and the Fund's decision to approve a stand-by were in the same relationship as offer and acceptance in the law of contracts, it could be argued that conditionality simply means a mem-

78. *Id.*

79. Article V, section 3(b)(i).

80. J. GOLD, CONDITIONALITY 3 (IMF Pamphlet Series No. 31, 1979).

81. J. GOLD, THE LEGAL CHARACTER OF THE FUND'S STAND-BY ARRANGEMENTS AND WHY IT MATTERS 7 (IMF Pamphlet 1970) [hereinafter cited as GOLD, LEGAL CHARACTER].

82. IMF DECISION No. 6056 (79/38), SELECTED DECISIONS, *supra* note 53, at 23.

83. *Id.*

84. Article XXX(b).

85. GOLD, LEGAL CHARACTER, *supra* note 81, at 2.

ber's undertaking to implement an adjustment program given in consideration for the Fund's financial support.[86] Stand-by arrangements would then be mere loan agreements. The non-contractual nature of stand-by arrangements, however, signifies that conditionality is an aspect of the unilateral power of the Fund to approve certain transactions or acts of a member as consistent with the Articles of Agreement and the Fund's policy and purposes. As a special kind of "qualified approval," conditionality need not be connected solely with IMF money. Instead, it can be invoked by the Fund whenever a member seeks to enjoy a privilege, the availability of which depends upon such member's actions being consistent with the Fund Agreement.[87]

IV. ARTICLE VIII, SECTION 2 CONDITIONALITY AND THE USE OF EXCHANGE CONTROLS BY DEBTOR COUNTRIES IN THE INTERNATIONAL DEBT CRISIS

A. *The "Maintained or Imposed Consistency With [The Fund] Agreement" Requirementof Article VIII, Section 2(b)*

The privilege of Article VIII, section 2(b) protection from foreign creditors is expressly made conditional upon the actions of a debtor country in resorting to exchange controls that are "maintained or imposed consistently with [the Fund] Agreement." These words refer to provisions of the Articles other than Article VIII, section 2(b).[88] The Articles recognize exchange controls in three main[89] provisions. Article VIII, section 2(a) provides that a member may not "impose restrictions on the making of payments and transfers for current international transactions" unless they are approved by the Fund or are authorized by other provisions of the Articles. Article XIV, section 2 establishes a limited immunity from Article VIII, section 2(a) for those members who wish to avail themselves of transitional arrangements before undertaking to perform certain obligations, including the obligation to avoid restrictions forbidden by Article VIII, section 2(a). Such members may "maintain and adapt to changing

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86. *Id.*

87. Such is the case for both Article V, section 3 and Article VIII, section 2(b). Article V, section 3 provides that "the Fund shall examine a request for a purchase to determine whether the proposed purchase would be consistent with the provisions of (the Fund) Agreement. . . ." Article VIII, section 2(b) provides that "exchange contracts that involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with (the Fund) Agreement shall be unenforceable in the territories of any member."

88. Gold, *Exchange Contracts, supra* note 60, at 800.

89. Two other, less significant, provisions refer to exchange controls: Article VII, section 3(b), which allows any member, after consultation with the Fund, "temporarily to impose limitations on the freedom of exchange operations in (scarce currencies);" and Article XI, section 2, which allows any member complete freedom to "impose restrictions on exchange transactions with non-members or with persons in their territories unless the Fund finds that such restrictions prejudice the interests of members and are contrary to the purpose of the Fund."

circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which [they] became member[s]."[90] Finally, Article VI, section 3 allows any member to "exercise such controls as are necessary to regulate international capital movements," provided that such controls will not "unduly delay transfers of funds in settlement of commitments."

For purposes of this paper, the transitional arrangements of Article XIV, section 2 can be disregarded, because that derogation from the prohibition of Article VIII, section 2(a) is limited to the exchange controls "in effect at the date on which [a country] became a member."[91] Article VIII, section 2(a) applies fully to any *new* exchange control regulations introduced by those Fund members still under the transitional regime of Article XIV.[92] Therefore, most situations of the kind at issue in *Allied Bank*, where exchange control regulations were resorted to as a response to an external payments crisis, would be outside the scope of Article XIV, regardless of whether the country imposing the exchange controls had accepted the obligations of Article VIII. For purposes of this paper, therefore, Article VIII, section 2(b) is triggered by two different kinds of exchange controls: those affecting current international transactions, provided that the prior approval of the Fund is obtained pursuant to Article VIII, section 2(a), and those affecting capital movements, provided that they are authorized by Article VI, section 3. The only difference between the two situations is that the former requires the positive approval of the Fund, while the latter does not. This distinction has important implications for the proposed concept of "Article VIII, section 2 conditionality," which is premised upon a need for Fund approval of a particular transaction.

B. *The Nature of International Debt Payments Under the Fund Agreement*

Since the concept of Article VIII, section 2 conditionality only oper-

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90. Article XIV, section 2. This provision, however, mandates that such members shall "as soon as conditions permit" lessen or withdraw restrictions maintained under the transitional regime. Article XIV, section 3 gives the Fund authority to put pressure on members under the transitional regime if it believes that "conditions are favorable for the withdrawal of any particular restriction, or for the general abandonment of restrictions, inconsistent with the provisions of any other articles of (the Fund) Agreement."

91. Article XIV, section 2. Once a member has given the IMF notice that it is no longer availing itself of the transitional arrangements, such member may not return to them. Article XIV, section 1. Furthermore, if a member withdraws a restriction, or abandons all restrictions, it may not reintroduce them under the transitional arrangements exception to Article VIII, section 2(a), but must instead obtain the Fund's approval. Gold, *Exchange Contracts*, *supra* note 60, at 780.

92. Such members must obtain the Fund's approval under Article VIII, section 2(a) even though they are still imposing other restrictions under the transitional regime, whether in the original or in an adapted form, that were in force when the member entered the IMF. *Id. See, e.g.*, J.K. HORSEFIELD, THE INTERNATIONAL MONETARY FUND 1945-1965: TWENTY YEARS OF INTERNATIONAL MONETARY COOPERATION, VOL. I: CHRONICLE 248-50 (1969).

ates when exchange restrictions affect current international payments, it is necessary to ascertain whether typical international loans involve current or capital transactions under the Articles. At first glance, both kinds of transactions would appear to be present, since an international debt requires interest and fee payments as well as repayment of principal.

Debt service payments regularly due to foreign lenders typically involve, for the greater portion, interest and fees for services performed in connection with the loans.[93] Interest and fees constitute "payments and transfers for current international transactions."[94] Article XXX(d) of the Fund Agreement contains a definition of current transactions:

> Payments for current transactions means payments which are not for the purpose of transferring capital and includes, without limitation:
> (1) all payments due in connection with foreign trade, other current business, including services, and normal short term banking and credit facilities;
> (2) payments due as interest on loans and as net income from other investments;
> (3) payments of moderate amount for amortization of loans and for depreciation of direct investment; and
> (4) moderate remittances for family living expenses.[95]

Paragraph (2) of the definition expressly covers interest payments and paragraph (1) includes fees for banking and credit services.

The repayment of the principal component of debt service also falls within the definition of current international transactions.[96] The expressions "amortization" and "moderate amount" in paragraph (3) of Article XXX(d) clearly refer to normal repayment schedules of long-term loans.[97] The question of what is meant by "moderate amount" cannot be answered precisely. Local experience and commercial practice must be the controlling standards.[98] A commentator, however, has said that "amortization payments which, for example, equal one-twentieth of the amount of a 20-year loan would certainly appear to qualify everywhere" as current transactions.[99] Another commentator suggested that the treatment of principal components of debt service as current payments for purposes of

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93. The actual composition of debt service payments depends, of course, on the terms of the loan.

94. Article VIII, section 2(a).

95. Article XXX(d).

96. EDWARDS, *supra* note 59, at 396. This author noted that, while exchange regulations relating to capital movements in the country of the borrower or in that of the lender could prohibit the loan from being made without triggering Article VIII, section 2(a), if the loan is lawfully made the exchange control regulations of the borrower's country must allow him to pay interest on the loan and reasonable amounts for amortization of the principal, as these payments become due, because they are treated as current payments by the Fund. *Id.*

97. *Id.* at 395 n.55.

98. Evans, *Current and Capital Transactions and How the Fund Defines Them*, 5 FIN. & DEV. 30, 34 (Sept. 1968).

99. *Id.*

exchange restrictions is justified by the regularity of such payments and by the disruption caused by their interruption, even if economists and accountants treat all repayments of principal as capital items.[100]

The question whether the full repayment of the principal of a loan in one lump sum, as opposed to payments of regular debt service, is a current or capital transaction is not so clear. The characterization of full repayment under the Articles is particularly important in a situation like the one at issue in *Allied Bank*, because of the acceleration clauses typically inserted in loan agreements. An acceleration clause makes the full amount of a loan due upon the happening of an event of default. If other loans to the same debtor contain cross-default clauses, default on a single loan can trigger a chain reaction whereby staggering amounts become immediately due to foreign creditors.

Common sense would seem to dictate that full repayment of a loan, just like the original making of the loan, be classified as a capital transfer. Article XXX(d)(1), however, characterizes as current "all payments due in connection with. . .normal short-term banking or credit facilities." Three questions must be answered in order to decide whether a particular loan falls within the definition of such facilities: what are "banking and credit facilities?;" what is "normal?;" and what is "short-term?" A commentator from within the Fund wrote that the facilities at issue are,

> [t]hose banking and credit facilities which are necessary to keep trade moving and to sustain current business operations. This is in contrast to those capital transactions referred to in Article VI, section 1(b)(i) which are needed to promote or expand operations above the present level by direct investment and transfers of working capital and which therefore can be regarded as being more than the "facilities" needed for current operations.[101]

The same commentator stated that "normal" facilities are those consistent with the customary practice in the particular trade or business for which the facility is made available.[102] This variable definition also applies to "short-term," therefore, no concrete rule can be fashioned.[103]

A plausible argument can be made that most of the recent commercial bank lending to developing countries for general balance of payments

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100. EDWARDS, *supra* note 59, at 395 n.55. That the legal definition of current payments under the Articles of Agreement differs from the definition subscribed to by economists is a calculated effect, rather than an anomaly. A commentator noted that "the divergencies were adopted by the Drafters of the Articles to attain certain policy objectives." Evans, *supra* note 98, at 30.

101. Evans, *supra* note 98, at 35.

102. *Id.*

103. *Id.* Evans noted that at the time when the original Articles were drafted, a one-year limit was normally placed on obligations incurred for current purposes and concluded that "a period of more than one year would probably not generally be considered 'short-term.' " *Id.* It should be kept in mind, however, that such a limit is not explicitly set forth in any provision of the Fund Agreement and that the Fund practice does not support any rigid test of the meaning of "short-term."

purposes fits the definition of the Article XXX(d)(1) facilities and therefore gives rise to current transfers. Other types of bank financing and inventory financing may or may not fall within the definition of such facilities, depending on their terms. It should be noted that the same loan may originally be a capital transfer and later become a current one pursuant to Article XXX(d)(1). This is particularly true for rescheduled loans and new credits extended in connection with the rescheduling, because of the "maintenance of trade" versus "expansion of trade" test under Article XXX (d)(1).[104] In any event, each loan must be examined in light of its origin, purpose, terms, and history to conclude whether it falls within the scope of the Article XXX(d)(1) facilities.

C. *The Allied Bank Scenario: Exchange Controls Affecting Regular Debt Service Payments*

Given the current nature of regular debt service payments (and possibly full repayment of principal) under the Articles, when a member seeks to impose exchange control regulations that might affect the ability of borrowers in such a country to make payments to foreign lenders when due, the Article VIII, section 2(a) prohibition against restrictions on current international transactions may be triggered. In that case, the proposed exchange controls will be consistent with the Fund Agreeement only if the Fund's prior approval is secured. The need for such approval provides the Fund with an opportunity to extend conditionality to the Article VIII, section 2(b) privilege of unenforcable claims.

The approval of the Fund, however, is not required for non-restrictive regulations of current payments.[105] In its interpretation of Article VIII, the Fund stated that "the guiding principle in ascertaining whether a measure is a restriction on payments and transfers for current transactions under Article VIII, section 2, is whether it involves a direct governmental limitation on the availability or use of exchange as such."[106] Article VIII, section 2(a) applies "regardless of the motivation for the restrictions and the circumstances in which they are imposed."[107] The Fund could find that restrictions are in existence even in the absence of formulated regulations prescribing such restrictions, as evidenced by the strict position taken by the Fund on payment arrears.[108] Payment arrears arise from governmentally imposed delays in making foreign currency

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104. *See supra* note 101 and accompanying text.

105. Article VIII, section 2(a) prohibits restrictions on current payments, while Article VIII, section 2(b) covers exchange control regulations. The term regulations is broader than the term restrictions, because regulations may be non-restrictive. Gold, *Exchange Contracts*, *supra* note 60, at 782. Consequently, non-restrictive regulations affecting current payments and transfers are consistent with the Fund Agreement without the need for approval by the IMF. Accordingly, they automatically trigger the protection of Article VIII, section 2(b).

106. IMF DECISION No. 1034 (60/27), SELECTED DECISIONS, *supra* note 53, at 241-42.

107. *Id.* at 242.

108. Gold, *Exchange Contracts*, *supra* note 60, at 782 n.19.

available for payments recognized as legitimate under a country's exchange control system. The Fund stated that "undue delays in the availability or use of exchange for current international transactions that result from governmental limitations give rise to payment arrears and are payment restrictions under Article VIII, section 2(a). . . . The limitation may be formalized, as for instance compulsory waiting periods for exchange, or informal or ad hoc."[109] Under these principles, any governmental regulation interfering with the availability of foreign exchange needed to make debt service payments to foreign lenders when due would fall within the Article VIII, section 2(a) prohibition against restrictions on current payments.[110]

If Article VIII, section 2(a) is triggered, the approval of the Fund is necessary before the Article VIII, section 2(b) defense can be claimed. It is through the need for such approval that Article VIII, section 2 conditionality comes into place. In other words, through the need for Article VIII, section 2(a) approvals, the availability of the Article VIII, section 2(b) defense by a debtor country, seeking to impose the exchange restrictions, can be conditioned upon adoption of austerity measures of the type normally associated with stand-by arrangements under Article V, section 3.

The mechanism for Article VIII, section 2 conditionality is already in place. The Fund has declared that before it will grant approval of proposed restrictions on current payments it must be "satisfied that the measures are necessary and that their use will be temporary while the member is seeking to eliminate the need for them."[111] The decision to approve the proposed exchange controls can be subjected to conditions at

109. Paragraph 1 of the *Conclusions* attached to IMF DECISION No. 3153 (70/95), SELECTED DECISIONS, *supra* note 53, at 244. The Fund reasoned that "restrictions resulting in payment arrears arising from informal or ad hoc measures do particular harm to a country's international financial relationships, because of the uncertainty they generate. This uncertainty is particularly harmful to the smooth functioning of the international payments system and has pronounced adverse effects on the credit worthiness of the debtor country, which may extend beyond the period of the existence of the restrictions." *Id.* at 244. An undue delay is defined by the Fund as "a substantial delay beyond that usually required for ascertaining the bona fides of exchange applications or the time that can be regarded as normally required for the administrative processing of applications for exchange." *Id.*

110. Realistically, a debtor country with a deteriorating foreign debt ratio and a shortage of foreign currency will primarily focus on debt service payments in its efforts to stop the hemorrhage of currency through exchange restrictions. Debt service is, in most circumstances, a major cause of a payment crisis for developing countries and there would not be much of a point in restricting other kinds of external payments only. Nowzad, *Debt in Developing Countries: Some Issues for the 1980's*, Fin. & Dev., March 1982, at 14.

111. IMF DECISION No. 1034 (60/27), SELECTED DECISIONS, *supra* note 53, at 242. Rule H-4 of the Fund's By-Laws, RULES AND REGULATIONS (40th ed. 1983), provides that the request for approval must be in writing and state the reasons for the request. Rule H-5, *id.*, provides that the decision to approve or not to approve is made by the Executive Board of the IMF. These procedures parallel closely those, for the approval of a stand-by arrangement.

the discretion of the Fund.[112] The Fund's decision on payment arrears makes this point explicit by declaring that a member requesting approval under Article VIII, section 2(a) "should be expected to submit a satisfactory program for [the] elimination [of the payment arrears]."[113] In many ways, therefore, Article VIII, section 2 conditionality is already implicitly used by the Fund, whenever approval of restrictions on current payments is requested by a member.

All that is needed to establish Article VIII, section 2 conditionality is an express link between Article VIII, section 2(a) approvals and Article VIII, section 2(b) unenforceability of exchange contracts, insofar as international loan agreements are concerned. Such a link is readily available because restrictions approved by the Fund are *ipso facto* "maintained or imposed consistently with [the Fund] Agreement."[114] Accordingly, the availability of Article VIII, section 2(b) relief for a debtor country in a liquidity crisis depends on the Fund's approval of the exchange restrictions sought to be imposed by such country to deal with a shortage of currency to service external debt.

D. *A Variation on the Allied Bank Scenario: Exchange Controls Affecting Repayments of Principal Only*

Since Article VIII, section 2 conditionality requires that the Fund be

112. All that is needed to make this process entirely parallel to the stand-by arrangements procedure is to require a member seeking approval to impose exchange restrictions on current payments to submit a "letter of intent" to the Fund, setting forth the purpose, type, and duration of the restrictions, as well as the policies and objectives of the adjustment program in support of which the restrictions are sought to be imposed. The Fund's decision granting approval under Article VIII, section 2(a) would then have to incorporate by reference the terms of the "letter of intent" and should expressly refer to the protection of Article VIII, section 2(b) as a necessary complement of the adjustment program. Such reference would comply with the procedure announced in IMF DECISION 446-4, SELECTED DECISIONS, *supra* note 53, at 233, where the Fund undertook to "advise whether particular exchange control regulations are maintained or imposed consistently with the Fund Agreement." *Id.* at 234. The Fund's decision could be pleaded in the courts of all members as conclusive evidence on the issue of unenforceability of a contract pursuant to Article VIII, section 2(b).

113. IMF DECISION No. 3153 (70/95), SELECTED DECISIONS, *supra* note 53, at 245. As a matter of fact, the Fund in this decision assumed that a member seeking approval of restrictions giving rise to payment arrears would also request a stand-by arrangement and that the same adjustment program would apply to both approvals:

> Fund financial assistance to members having payment arrears should be granted on the basis of performance criteria or policies with respect to the treatment of arrears similar to the criteria or policies described in the preceding paragraph for the approval of the payment restrictions. In general, the understandings should provide for the elimination of the payment arrears within the period of the stand-by arrangements.

Id.

114. EDWARDS, *supra* note 59, at 483; Gold, *Exchange Contracts, supra* note 60, at 784. Sir Joseph Gold wrote that "if the IMF has approved regulations, to hold that nevertheless they are inconsistent with the purposes of the IMF would mean that the IMF has failed the direction in the last sentence of Article I: 'the Fund shall be guided in all its policies and decisions by the purposes set forth in this article.' " *Id.*

given an opportunity to intervene, there cannot be an imposed Fund conditionality if no current restrictions are imposed. This means that a debtor country could attempt to make available to domestic borrowers the protection of "Article VIII, section 2(b) conditionality," by solely restricting the repayment of external debts in one lump sum, while not interfering with the availability of foreign exchange for regular debt service payments.[115] So long as full repayment of a loan does not fall within the definition of current transfers in Article XXX (d)(1) (the loan not being trade-related or short-term)[116] such exchange restrictions would only affect capital movements. It is possible that this conduct would allow a debtor in bad faith to default on an international loan by, for example, ceasing debt service payments and still seeking to take advantage of the Article VIII, section 2(b) defense in an action for breach of contract brought by foreign lenders in the court of another member. In fact, the borrower could argue that capital controls are authorized by Article VI, section 3 [117] and therefore, are automatically "maintained or imposed consistently with [the Fund] Agreement"[118] without the need to request the Fund's approval.[119] If the restrictions were indeed authorized by Article VI, section 3, the courts of all members would be forced to deny the enforceability of international loan agreements, insofar as acceleration clauses and cross-default clauses are concerned, because they would be contrary to the legitimate exchange controls of another member.

This does not mean that the courts of all members would be powerless to grant relief to creditors against a debtor in breach, because Article

115. The problem with this scenario is that conditionality effectively forces a member seeking to impose exchange restrictions to implement an adjustment program aimed at correcting the causes of the member's difficulties and thereby eliminate the need for the restrictions. Without conditionality, such adjustment efforts, which are normally highly unpopular politically, might never be undertaken.

116. *See supra* text accompanying notes 101-103.

117. Article VI, section 3 provides that "members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments." A "control" authorized by Article VI, section 3 can be defined as a governmental action directly related to the availability or use of exchange for making capital transfers, regardless of whether such control is restrictive or nonrestrictive. J. GOLD, INTERNATIONAL CAPITAL MOVEMENTS UNDER THE LAW OF THE INTERNATIONAL MONETARY FUND (IMF Pamphlet Series No. 21, 1977) [hereinafter cited as GOLD, CAPITAL MOVEMENTS]. This definition of controls under Article VI, section 3 makes the term coextensive with "exchange control regulations" in Article VIII, section 2(b), insofar as capital movements are concerned. *Id.* at 6.

118. It is safe to assume that all regulations included within the Article VI, section 3 authorization are consistent with the Fund Agreement. This is not, however, to say that all capital controls are within the Article VI, section 3 authorization, as will be shown *infra*, text accompanying notes 121-131.

119. If this argument were accepted, there would be no occasion for the Fund to apply conditionality to the imposition of exchange restrictions imposed by debtor countries to deal with their external debt problems. The benefit of Article VIII, section 2(b) would thus be available to debtor countries "at no cost" and adjustment efforts might never be undertaken.

VIII, section 2(b) only applies to exchange contracts, and not to court orders. Payment in full of the outstanding amount of the loan, plus any eventual damages, would be due by the defaulting borrower as a judgment debtor, not as a contract debtor. Moreover, the judgment debt would arise from the breach of a contract whose terms are in no way contrary to the exchange regulations of any member, since by hypothesis, the country of the borrower would not interfere with the making of debt service payments in accordance with the terms of the loan.

While Article VIII, section 2(b) does not address the situation where a court order is contrary to the legitimate exchange controls of any member, other doctrines, such as act of state or international comity, may be relevant. Nevertheless, it seems unlikely that any court would refuse to grant relief against a defaulting debtor who breached in bad faith, because the debtor's country, arguably also in bad faith, tried to shield the debtor from such relief through foreign exchange restrictions. The *Allied Bank II* holding that the Costa Rican exchange restrictions constituted an extraterritorial taking of property, and were therefore not entitled to the protection of the act of state doctrine, strongly supports this conclusion, at least when the situs of the debt is outside the country of the defaulting debtor. When the situs of the debt is in the debtor's own country, international comity (or lack thereof) can be claimed to deny recognition to exchange controls on capital transfers when they interfere with the enforcement of judicial remedies against a debtor in breach. Again, *Allied Bank II* can be used as authority for such a proposition.

Similar issues would be raised if a debtor country restricted both full repayment of external debts and the making of debt service payments, but the Fund's approval for the latter restrictions, affecting current payments, were neither sought nor granted. The conclusions reached in the case where only capital controls were imposed would be even more compelling in this case. Since the loan agreement on which the borrower defaulted would not be contrary to any legitimate exchange regulations of a member, unapproved current restrictions being inconsistent with the Fund Agreement, the courts of any member would still have full power to enforce the contract according to its terms. The debtor country would then be in an even worse position to claim that its capital controls should be respected by a foreign court on grounds of comity or act of state, because such country would have breached its obligations under an international treaty.

E. *Some Reflections on the Policy of the Fund Agreement: Article VI, Section 3 Capital Controls and International Loans*

Even though a debtor country would be unable to defeat Article VIII, section 2 conditionality through Article VI, section 3 capital controls (with the possible exception of acceleration and cross-default clauses), there is something disconcerting about the statement that Fund members can, consistently with the Fund Agreement, prohibit the repayment of international loans pursuant to Article VI, section 3. It is submitted that such a statement is overbroad and possibly repugnant to the true policy underlying the Articles. Article VI, section 3, in fact, is not an unqualified, blanket authorization for any exchange restriction purporting to regulate capital movements. The Agreement itself, as well as the history and practice of the Fund, imposes various limitations on a member's ability to control capital transactions.[120] Capital controls, for example, are prohibited by Article VI, section 3 if they "unduly delay transfers of funds in settlement of commitments."[121] The meaning of this clause is ambiguous and it may relate to current or capital transactions only or to both.[122] A reasonable interpretation is that the clause refers to "commitments to make capital transfers entered into before a restriction is imposed on capital transfers."[123] Under this interpretation, exchange controls that would impede the repayment of prior loans would be prohibited by Article VI, section 3. As such, they would be inconsistent with the Fund Agreement and the Article VIII, section 2(b) defense would be unavailable.

Moreover, the Fund's interpretation of Article VI, section 3 states that in regulating capital movements members should pay "due regard. . .to the general purposes of the Fund."[124] Although the purposes of the Fund in Article I do not expressly address capital movements, there is ample evidence that Lord Keynes, as well as other drafters of the Bretton Woods Agreement, contemplated a distinction between loans from creditor countries to debtor countries to develop resources or maintain equilibrium, which they deemed desirable, from short-term speculative movements or flights of currency from deficit countries, which they viewed as

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120. A possible, and very effective, argument against the availability of the Article VIII, section 2(b) defense in these circumstances would be that in general, foreign exchange restrictions imposed after the conclusion of a contract do not come within Article VIII, section 2(b). This position is supported by Dr. Mann, who maintains that "Article VIII(2)(b) is concerned with the effectiveness of contracts, that is to say, with their initial 'validity' rather than the legality or possibility of their performance." MANN, LEGAL ASPECTS OF MONEY, *supra* note 60, at 377. Accordingly, he wrote, "contracts which at the date of their conclusion are consistent with, but during their lives become contrary to the regulations cannot be caught by [the text of Article VIII(2)(b)]." *Id.* at 378.

For purposes of analysis in this paper, however, it is indispensable to assume that subsequent exchange restrictions do in fact trigger the protection of Article VIII, section 2(b). *See supra*, note 73 and accompanying text. The very concept of "Article VIII, section 2(b) conditionality" is rendered meaningless by a realization of this assumption, insofar as exchange restrictions are used as a means to deal with payment crises after incurring external debt. It is therefore impossible to rely on the argument outlined above in this paper. To maintain that subsequent restrictions on current transactions are within the Article VIII, Sections 2(b) protection, but subsequent restrictions on capital transactions are not, would be a little like wanting to have your cake and eat it, too.

121. Article VI, section 3.

122. GOLD, CAPITAL MOVEMENTS, *supra* note 117, at 55 n.22.

123. *Id.* Sir Joseph Gold wrote that the argument against assuming that the clause relates exclusively to current transactions is that such transactions are mentioned expressly in the preceding clause. *Id.* There are, however, arguments in favor of a contrary interpretation. *Id. See, e.g.*, EDWARDS, *supra* note 59, at 456 n.357.

124. IMF DECISION NO. 541 (56/39), SELECTED DECISIONS, *supra* note 53, at 116.

undesirable.[125] It can reasonably be concluded that the freedom to control capital movements was not intended to impede international transfers of productive capital.[126] While the distinction between productive capital and speculative capital is far from clear in practice,[127] it is reasonable to assume that most commercial bank loans to foreign governments for general balance of payments support, as well as most bank loans for investment projects and financing of inventory, constitute productive capital flows.

Although the purposes of the Fund in Article I contain no explicit reference to productive capital, several implicit references to it have been suggested. One of the purposes of the IMF is "to assist . . . in the elimination of foreign exchange restrictions which hamper the growth of world trade."[128] Sir Joseph Gold suggested that among the restrictions to be eliminated are those that inhibit the flow of productive capital.[129] Other implicit references to productive capital might be seen in Article I(ii), which mentions the "expansion and balanced growth of international trade" as one of the purposes of the Fund, and in Article I(iii), concerning the promotion of exchange stability.[130] Moreover, after the second amendment to the Fund Agreement, Article IV, section 1 refers to the exchange of capital among countries as an essential purpose of the Fund.[131] A plausible argument can be made that, insofar as capital controls imposed by debtor countries make it impossible for borrowers to repay foreign lenders, they disrupt the flow of productive capital from creditor countries to deficit countries. To the extent that this disruption hampers the balanced growth of world trade, and impedes the free exchange of capital among members, the exchange restrictions affecting capital transfers conflict with the purposes of the Fund. As such, they are not authorized by Article VI, section 3 and therefore, are inconsistent with the Fund Agreement.

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125. *See generally* GOLD, CAPITAL MOVEMENTS, *supra* note 92, at 7-12.

126. *Id.* at 8. Productive capital simply means "a more than temporary addition to the capital stock of the recipient country." *Id.* at 9. Productive capital should be contrasted with speculative capital. The former creates long-term, equilibrating flows, the latter creates short-term disequilibrating flights from the currency of a country whose economy is weakening. *Id.* at 6-7.

127. *See generally* EDWARDS, *supra* note 59, at 458-9.

128. Article I, section 4.

129. GOLD, CAPITAL MOVEMENTS, *supra* note 117, at 12.

130. *Id.* at 13.

131. The Fund's interpretation of Article VI, section 3 expressly mandates that a member's regulation of capital movements not interfere with the provisions of Article IV. IMF DECISION No. 541 (56/39), SELECTED DECISIONS, *supra* note 53, at 116. Article IV, section 1(iii) provides that a member must not manipulate exchange rates in order to prevent balance of payments adjustment or to gain an unfair competitive advantage over other members. To the extent that capital controls conflict with these mandates, they are prohibited by Article VI, section 3.

V. ARTICLE VIII, SECTION 2 CONDITIONALITY AND THE ALLIED BANK SITUATION

It is interesting to see how the situation at issue in the *Allied Bank* litigation could have been handled if Article VIII, section 2 conditionality had been used. If such a procedure had been available when Costa Rica had to confront its economic crisis and the consequent shortage of foreign currency, the Costa Rican government would not have declared a unilateral halt to the payment of debt service to foreign lenders . Instead, Costa Rica would have requested the Fund to approve exchange control restrictions affecting current payments and it would have agreed with the Fund on an adjustment program to be implemented to remedy the country's economic crisis, so that in due time the exchange restrictions could be withdrawn. The Fund would have approved the restrictions under Article VIII, section 2(a) conditioned upon the adoption of austerity measures. If, following a default of debt service, the foreign lenders had sought to exercise their creditors' remedies in the United States courts, the Costa Rican borrowers would have simply had to plead the Fund's decision to secure a dismissal of the action because of Article VIII, section 2(b). Faced with the inability to enforce their contracts in the courts of any member, all the foreign lenders would have had no choice but to join in the rescheduling of the debt. At the same time, the lenders would have had the comfort of the Fund's supervision of Costa Rica's adjustment efforts and could have confidently looked forward to a resumption of regular payments, pursuant to a schedule agreed upon by the Fund and Costa Rica. The foreign lenders would not have had the opportunity to interfere with the rescheduling or the adjustment process by resorting to litigation, as Fidelity did in *Allied Bank*. At the same time, the rights of lenders would have been safeguarded and investors' confidence would not have been disrupted because of the Fund's role as "guarantor" of the entire rescheduling and adjustment.[132]

If Article VIII, section 2 conditionality had been used to handle the Costa Rican debt crisis, the cooperative adjustment of international debt problems under the auspices of the IMF, so highly praised by both the *Allied Bank II*[133] court and the U.S. government, would have been strengthened, while all the drawbacks complained of by the lenders in their criticism of the *Allied Bank I*[134] decision would have been avoided. This conclusion is supported by an examination of the arguments offered by the parties and *amici* in the course of the *Allied Bank* litigation.

The United States government, as *amicus*,[135] argued on rehearing

132. In a lot of ways, the outcome would have been identical to that normally secured through stand-by arrangements and Article V, section 3 conditionality, as, for example, in the Mexican crisis of 1982.

133. 757 F.2d 516 (2d Cir. 1985). *See supra* note 5 and accompanying text.

134. 733 F.2d 23 (2d Cir. 1984)(withdrawn). *See supra*, note 1 and accompanying text.

135. *See supra* note 3 and accompanying text.

that the *Allied Bank I* decision was inconsistent with the "strategy of voluntary cooperation" heretofore adopted to deal with the debt crisis.[136] According to the *amicus*, such a strategy requires strong adjustment efforts by debtor countries and cooperative action on the part of the international financiers. This strategy works best when the IMF serves as an "objective mediator," by approving the economic austerity measures developed by the debtor, establishing external financing requirements, and acting as a catalyst in arranging new loans.[137] The brief for the United States cited numerous U.S. government sources to show that the United States strongly supports this approach, including a strong role for the IMF.[138] They argued that this approach is disrupted by judicial recognition of a country's unilateral suspension of payments on its foreign debt. This position met with full approval of the Second Circuit in *Allied Bank II*, which held that international cooperation and negotiation in the context of private international debt difficulties is highly desirable and demands that lenders display full confidence in the validity and enforceability of their contract rights.[139] If there were unilateral deferments of debt service on external loans by debtor countries through foreign exchange restrictions, there would be a real danger that borrowers would be in a position to "jawbone" their foreign lenders. The bargaining process would become skewed and unbalanced, and cooperation between the parties would become impossible. Article VIII, section 2 conditionality, however, is the opposite of unilateral rescheduling. Article VIII, section 2 conditionality would maximize the chances of effective cooperation between borrowers and lenders by giving the IMF strong, direct leverage in dealing with both. All of the parties involved would have a strong incentive (and no viable alternative) to join in the "cooperative adjustment of international problems" truly under the auspices of the Fund.

Both the United States government and the Clearing House, as *amici*, criticized the analogy drawn by the *Allied Bank I* court between Costa Rica and a debtor filing for reorganization under Chapter 11 of the U.S. Bankruptcy Code.[140] *Amici* argued that the lack of a "previously recognized neutral body acting as a kind of bankruptcy court" and the lack of fundamental procedural safeguards to protect the interests of all creditors make the two situations radically different.[141] *Amici* argued that the

136. Brief for the United States as *amicus curiae* on Rehearing at 8, Allied Bank International v. Banco Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1985) [hereinafter cited as United States Brief].

137. *Id.* at 9.

138. *Id.* at 10 n.6.

139. 757 F.2d at 519.

140. This analogy was one of the main reasons why the Second Circuit in *Allied Bank I* affirmed the lower court's decision in favor of the defendants. *See supra* notes 34-36 and accompanying text. The same court in its *Allied Bank II* decision made no mention of the analogy. *See supra* note 38 and accompanying text.

141. United States Brief, *supra* note 136, at 13 n.9. Brief for the New York Clearing House Association as *amicus curiae* on Rehearing at 3, Allied Bank International v. Banco

analogy was faulty because a debtor cannot be allowed to "declare itself to be bankrupt and then dictate the terms of its creditors' remedies,"[142] without any assurance that an "impartial plan of adjustment" will be adopted.[143] All of these concerns would be addressed if Article VIII, section 2 conditionality were used, because the Fund would indeed assume the role of a neutral third party. The Fund would approve and oversee the debtor's adjustment efforts, thereby safeguarding the interests of all creditors. Procedures could be put in place for periodic consultation between creditors and the Fund so as to avoid an unregulated "cramdown" of a reorganization agreement between a debtor country and a majority of its creditors on an unwilling minority.[144]

All the parties in *Allied Bank* recognized the critical link between lenders' confidence in the enforceability of their loan agreements and their willingness to extend new credit to sovereign borrowers.[145] A continuous flow of foreign commercial lending to sovereign debtors is essential if a generalized solvency crisis is to be avoided and the stability of debtor countries preserved.[146] The recognition of unilateral deferments on payments of foreign debt would make the banks even more reluctant to put new money into a country that is rescheduling its external debt, while an extension of conditionality to Article VIII, section 2(b) would increase their willingness to do so. It is well known that lenders' confidence is boosted by the adoption of IMF backed austerity measures by debtor countries in connection with stand-by arrangements.[147] If the Fund can require of sovereign debtors the adoption of similar austerity measures as a condition for granting approval of exchange restrictions under Article VIII, section 2(a), there is no reason why foreign lenders should not be equally reassured. In fact, Article VIII, section 2 conditionality would greatly increase the Fund's leverage in dealing with commercial lenders as

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Credito Agricola de Cartago, 757 F.2d 516 (2d Cir. 1984) [hereinafter cited as Clearing House Brief].

142. Clearing House Brief, *supra* note 9 at 3.

143. Clearing House Brief, *supra* note 141, at 27.

144. United States Brief, *supra* note 136, at 13 n.9.

145. *See, e.g.*, Clearing House Brief, *supra* note 141, at 23, and United States Brief, *supra* note 136, at 7.

146. A recent commentator noted that "from the borrowing countries' perspective, the debt problem is an economic growth problem. Their main concern is to acquire enough foreign exchange to import the necessities to sustain economic growth while simultaneously paying debt service . . . .These dual objectives of growth and debt service are at times in conflict. But if the banks do not opt for growth, their chances of repayment are substantially reduced. Thus, the banks are willing, in conjunction with a financial stabilization program, to put new money into a country that is rescheduling debt." Meissner, *Debt: Reform Without Governments*, 56 FOREIGN POL'Y 81, 82-83 (1984).

147. Lipson, *Bankers' Dilemmas: Private Cooperation in Rescheduling Sovereign Debts* at 2 (1984, unpublished) [hereinafter cited as Lipson, *Bankers' Dilemmas*]. The author writes that "as far as both creditors and debtors are concerned, the IMF's credits are far less important than its approval of the proposed austerity measures. Without such approval, and the continuing oversight that goes with it, creditors will not reschedule sovereign debt." *Id.*

well as borrowers, because of the binding effect of Article VIII, section 2(b) on private contract creditors. It has been written that after the Mexican crisis, the Fund has increasingly gone beyond a mere supervisory role with regard to austerity measures and has played an active role in arranging an overall financing package for the debtor.[148] The Fund has gone so far as to indicate a level of new commercial lending that should be part of the overall adjustment program and to refuse to sign a stabilization agreement until that level was met.[149] Article VIII, section 2(b) can be a formidable lever available to the Fund to pressure foreign banks to extend new credit since it effectively bars them from any judicial or administrative remedy for default.[150] Consequently, Article VIII, section 2 conditionality would invigorate and assure a flow of new money to rescheduling debtors, instead of interrupting it.

The main argument raised by the borrowers in *Allied Bank*, supporting recognition of the Costa Rican exchange restrictions, was that voluntary rescheduling is always vulnerable to the attempts of a recalcitrant creditor bank to secede from the restructuring, to demand special privileges, to call a default on its loans, and to secure a judgment and execution in a foreign court, thereby causing the entire rescheduling effort to crumble.[151] The defendants noted that the "rogue bank" is often "beyond the influence of either its peers or its government,"[152] and suggested that granting recognition to foreign exchange restrictions in the United States courts is "the last restraint on a recalcitrant creditor and provides the means for judicial action which does not place the fate of a restructuring exclusively in the hands of private sector arm wrestling."[153] Plaintiff and *amici*, on the other hand, tried to convince the court that the problem of recalcitrant banks was of no concern.[154]

The increasing difficulty and fragility of the process of voluntary debt rescheduling, due to the unwillingness of smaller banks to cooperate with the larger creditors, is well known.[155] The danger of a "domino ef-

148. Lipson, *International Debt and International Institutions* at 10, 12 (1984, unpublished).

149. *Id.* at 12.

150. IMF DECISION No. 446-4, SELECTED DECISIONS, *supra* note 53, at 233.

151. Defendant's Brief, *supra* note 9, at 4, 15, 20.

152. *Id.* at 20.

153. *Id.* at 21.

154. The Clearing House argued that "it is not at all uncommon in the rescheduling of foreign loans for one or more banks to decline to participate. In some instances these banks have been bought out by other participants . . . and in others they have been paid by the debtor after threatening litigation." Clearing House Brief, *supra* note 141, at 5.

155. Lipson, *Bankers' Dilemmas*, *supra* note 147, at 4. The author notes that "if we expect large banks to cooperate because of their heavy outstanding commitments to sovereign debtors and because of their status as permanent fixtures of the Euromarkets, then we would expect to find the holdouts, outliers and mavericks among the smaller banks with fewer international links . . . . The aim of the holdouts is essentially to reduce their exposure without any loss of asset value. To do so, however, reduces the debt available to the borrower and may imperil the entire rescheduling if other creditors follow suit." *Id.*

fect" triggered by a default called by a smaller bank is constantly a threat hanging over the entire rescheduling process.[156] Although there are very harsh informal sanctions against recalcitrant banks, the danger that the rescheduling will "unravel like a cheap sweater" and a "mad scramble of creditors for assets"[157] will be unleashed cannot be avoided. There are increasing doubts about the continuing ability of the large international banks to secure voluntary cooperation from all creditors by "private sector arm wrestling."[158] *Allied Bank II* may very well decrease such ability to a large extent, since it is now proven that a single creditor bank can refuse to join the rescheduling and can obtain judicial relief against the debtor.[159] Article VIII, section (b) would *ipso facto* resolve the problem of recalcitrant creditors, because it would foreclose any hope of obtaining satisfaction of their rights outside the restructuring process. This is indeed what happens in a domestic reorganization of a business under Chapter 11 of the Bankruptcy Code once a plan of reorganization has been adopted.

VI. ARTICLE VIII, SECTION 2 CONDITIONALITY AND THE FUND'S ROLE IN THE INTERNATIONAL DEBT CRISIS: THE NEEDED SYSTEMIC SOLUTION

These thoughts on the potential for Article VIII, section 2 conditionality raise some fundamental issues for future debate concerning the role of the IMF in the inter-ntional debt crisis. The main question is whether the traditional instruments used by the Fund to deal with the growing burden of external debt, namely conditionality under the stand-by arrangements of Article VI, section 3 are adequate to deal with an international financial system that is profoundly different from the one where such instruments were first developed.[160] In today's system, international banks are no longer simple channels for short-term capital movements induced by trade or by speculation,[161] but are also principle suppliers of

156. Lipson again writes that "the threat to call a formal default and force the acceleration of payments is another potential source of leverage for small creditors. . . . Since all international loan agreements contain cross-default clauses, some observers have suggested that a single default could start a prairie fire. . . ." *Id.*

157. *Allied Bank I*, 733 F.2d at 26.

158. Lipson, *Bankers' Dilemmas*, *supra* note 147, at 19.

159. The day after the *Allied Bank II* decision, the Wall Street Journal quoted a lawyer associated with the case as saying that the decision "is going to encourage small banks to demand repayment of overdue debt and make international restructurings much more difficult." Wall Street Journal, Mar. 19, 1985, at 4, col. 1.

160. Sir Joseph Gold wrote that:

> a development of recent years that was not foreseen at the time when the original Articles were negotiated is the emergence and enormous growth of international capital markets in various parts of the world. The development of these markets, which for convenience can be referred to collectively as the Eurocurrency market, has become a cardinal element of the international monetary system.

GOLD, CAPITAL MOVEMENTS, *supra* note 117, at 2.

161. Typical international capital flows are generated by the need to settle trade and

productive capital to fuel the growth of developing countries.[162] While in the old scenario international banks were able to precipitate a nation's currency crisis indirectly by amplifying the pressures generated by other actors, mainly speculators,[163] in the new scenario large banks are in a position to cause such crises directly because of their status as contract creditors.

The drafters of the original Articles were mostly concerned with current transfers and payments for trade-related transactions and with international flows of speculative capital, or "hot money."[164] Capital flights away from weakening currencies were particularly disruptive of international monetary stability. When a nation's economy weakened or strengthened, making its currency a candidate for adjustment, the banks acted as conduits for speculators, or as speculators themselves, and were the instruments of a "run" of the currency. The real battle was between speculators selling or buying foreign currency and central banks buying and selling domestic money. The battlegrounds were the foreign exchange markets and the controlling factor was the level of reserves available to counter speculation. When the pressure became too intense, central banks would call the IMF to their rescue; stand-by funds would become available to replenish reserves and a severe austerity package would be introduced to restore confidence in the currency. Article V, section 3 conditionality became the perfect instrument to manage this kind of crisis.

In the 1970's, however, the system changed because of the great success of commercial banks in recycling the petro dollar glut.[165] By increasing their balance of payments lending to unprecedented levels, commercial banks became direct actors in the system, rather than mere conduits or magnifiers of pressures generated elsewhere. Given their enormous net exposure toward developing countries, commercial banks are now in a position to cause an international solvency crisis by simply refusing to reschedule sovereign debts. The fact that banks have everything to lose from a generalized default of international loans, does not change the conclusion that the battle today is no longer between speculators and cen-

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other current transactions when a country experiences a surplus or a deficit in the current account of its balance of payments, by the desire of corporations to hedge anticipated payments or receipts to be made in foreign currencies or to maintain working balances, by differentials in interest rates available on short-term investments in one country compared to another, or by predicted changes in currency exchange rates influencing the decisions of investors on the deployment of their reserve funds. EDWARDS, *supra* note 59, at 453.

162. Large scale lending by commercial banks directed toward non-oil exporting developing countries developed out of the oil crisis of 1973. Commercial banks typically have provided funds to private and public firms for investment projects, financing of inventory and the like. *Id.* at 129. Commercial bank lending to foreign governments directly for balance of payments support is a relatively new phenomenon, but has reached massive proportions. *Id.*

163. Aronson, *Financial Institutions in the International Monetary System*, 12 CASE W. RES. J. INT'L L. 341, 343 (1980).

164. GOLD, CAPITAL MOVEMENTS, *supra* note 117, at 1.

165. *See, e.g.*, EDWARDS, *supra* note 59, at 130.

tral banks, but rather between contract creditors and debtors with cash flow problems. The battleground is no longer the exchange markets, but the markets for the developing countries' exports, their domestic markets for imports and the money markets of New York City with their fluctuating yields. The crises today are not caused by speculative fever, but by a steadily deteriorating external debt ratio in a world of high interest rates.

So far the Fund has had to rely on its traditional instruments to address the problems posed by this new scenario.[166] Beginning with the Mexican crisis, the Fund, on the invitation of the creditor and debtor countries, has greatly increased its direct participation in multilateral negotiations to reschedule the external debt of several developing members.[167] The Fund's new role, however, has had to rely on the old script of stand-by arrangements and Article V, section 3 conditionality.[168] These old instruments might be increasingly inadequate for the new task.

While the Fund's involvement via a stand-by arrangement undoubt-

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166. Sir Joseph Gold wrote that "the disturbances of the international monetary system and the growth of a vast international capital market that is not subject to international regulation have led to suggestions that the formal powers of the Fund in relation to capital transfers should be increased. These suggestions have made no progress." GOLD, CAPITAL MOVEMENTS, *supra* note 117, at 46.

167. *Id.* at 47. The Fund maintains a closer liaison with private financial institutions and with other international organizations on the volume and terms of financial flows and on the debt problems of developing members. In the rescheduling process, the Fund has provided technical and advisory services, has made financial assistance available to debtors to assist them in their efforts to resume normal economic relations and their development programs, and has made impartial evaluations of progress by debtors following the renegotiation. *Id.*

168. Gold provided a clear summary of the Fund's use of stand-by arrangements to deal with the international debt crisis:

> In reaching understandings with members on financial support for their economic and financial programs, the Fund emphasizes policies that will help a member to eliminate the conditions responsible for a disequilibrating outflow of capital or to establish the conditions that will promote the inflow of equilibrating or productive capital. For example, some members in persistent balance of payment difficulties have accumulated arrears on current payments and have faced the possibility of default in servicing external debt. These difficulties have had a detrimental effect on capital inflow and have induced capital outflow, with the result that the member's problems have been intensified. The Fund sought, therefore, to reach understandings with a member on policies that will improve its medium-term balance of payments prospects and in this way provide for a continuation of debt service and encourage capital inflow. Programs supported by the Fund often include provisions dealing with management of the member's external debt and limitation of the amount of medium-term external debt to be undertaken or guaranteed by the public sector and sometimes the private sector. The Fund pays much attention to the question whether a member's borrowing abroad is to support a development program or is for general budgetary or balance of payments purposes. The Fund may advise a member that the volume of borrowing for these purposes may mask a need for adjustment, which will become more difficult if the foreign indebtedness does not increase the capacity to service it.

Id. at 46-47.

edly causes a strong boost in foreign lenders' confidence and increases their incentive to remain in the balance of payments financing business,[169] the Fund's role is indirect and through persuasion, instead of being direct and binding. The Fund has a powerful influence on international private lenders, but lacks any direct regulatory authority upon them. In other words, the Fund lacks any direct leverage over recalcitrant lenders, except for the ultimate threat of refusing its assistance altogether and watching the system collapse. The positive conclusion of the rescheduling process depends upon the good will and wisdom of creditor banks and their ability to compel recalcitrant banks to contribute their share.

The Fund has so far been remarkably successful in bringing lenders and borrowers together on the appropriate adjustment programs and in persuading private lenders to produce enough new credit to support them. The process, however, is constantly vulnerable to the demands of "holdout" or "rogue" banks, who can always resort to litigation to enforce their creditors' remedies. The size and number of these recalcitrant lenders might very well increase as the size and number of debt reschedulings increase. The process is therefore skewed, because the Fund's powerful leverage over debtor countries via conditionality is not paralleled by any direct authority of the Fund over private lenders. There are reasonable grounds to fear that the old instruments used by the Fund will not succeed in eliminating the risk of a system collapse.

Article VIII, section 2 conditionality could be the needed systemic and institutional solution, in a situation like *Allied Bank*. Using Article VIII, section 2(a) in combination with Article VIII, section 2(b), the Fund would be able to extend indirectly its regulatory authority to private international lenders. The proposed approach would give the Fund a good measure of direct control over the debt restructuring process, because Article VIII, section 2(b) would indeed become the functional equivalent of a reorganization in bankruptcy. The binding effect of Article VIII, section 2(b) on the courts of all members makes it the equivalent of an automatic stay of all collection actions by international creditors. As a price for such immediate and complete, if only temporary, relief, debtor countries would

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169. Sir Joseph Gold again summarized this effect very concisely:

> Approval by the Fund of a stand-by or extended arrangement for a member under which the member can purchase foreign exchange is a signal to other potential lenders, whether international, public, or private, that the member's policies are adequate to bring about balance of payments adjustment. Not infrequently, these potential lenders await announcement of favorable action by the Fund and then make their own resources available. This finance may be substantially in excess of the resources provided by the Fund. Moreover, other lenders may make the continued availability of the resources they agree to provide dependent on the member's observance of the terms of the arrangement with the Fund and the member's continued ability to obtain foreign exchange from the Fund in accordance with the arrangement.

Id.

have to renounce unilateral deferments on external payments through foreign exchange restrictions and accept the conditions of an IMF backed adjustment program. The incentive for a defaulting debtor country to seek the Fund's assistance would indeed be great. Article VIII, section 2 conditionality would also make the system symmetrical by giving the Fund equal leverage over both lenders and borrowers. Article VIII, section 2 conditionality could become the linchpin of the Fund's contribution to solving the external debt crisis of developing members.