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# Foreign Exchange Rates: Legal Aspects and the Management and Minimization of Risk

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## **FOREIGN EXCHANGE RATES: LEGAL ASPECTS AND THE MANAGEMENT AND MINIMIZATION OF RISK**

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### **I. INTRODUCTION**

The growth of international trade has resulted in an increasing number of American businesses dealing in foreign currencies. Whenever a company obligates itself in something other than its own domestic currency, it faces exchange rate risks. Exchange rate risks result from a change in the rates of currency value of one country to currency value of another country. The following example illustrates the principle of exchange rates: assume an American company agrees to sell a product to a Canadian company. At the time the contract is signed, the selling price, in United States dollars, is \$100,000. The Canadian currency per United States dollar is 1.3800. Based upon this exchange rate of 1.38 Canadian dollars per \$1.00 United States dollars, the American firm agrees to accept 138,000 Canadian dollars, payable in 90 days. If the exchange rate at the time payment is received is still 1.38 to \$1.00, then the American firm will receive 138,000 Canadian dollars, and will convert it to \$100,000 United States dollars. If the Canadian dollar strengthens in relation to the United States dollar and the exchange rate at the time of payment is 1.30 to \$1.00, then the American firm will receive 138,000 Canadian dollars and will convert this to \$110,400 United States dollars. The firm will have benefitted from the shift in exchange rates by \$10,400 United States dollars. However, if the Canadian dollar weakens in relation to the United States dollar and the exchange rate at the time payment is received is 1.45 to \$1.00, then the American firm will receive 138,000 Canadian dollars and will convert it to \$95,172.41 United States dollars. The American firm will have lost \$4,827.59 United States dollars because of the shift in exchange rates.

This note focuses on two aspects of the exchange rate problem. Some of the techniques utilized by business organizations to minimize

or eliminate exchange rate risks is the first focus of this note. Business organizations are often unwilling to accept exchange rate risks because of the possibility that a profitable transaction can easily change to a losing proposition if there is an adverse move in the exchange rate. For this reason, firms must take steps to manage exchange rate risks. In addition, the growth of international trade has resulted in an increase in the number of court cases involving international transactions. The legal issues associated with exchange rates and the courts' resolution of these issues is the second focus of this note.

## II. HISTORY OF EXCHANGE RATES

In 1873, the United States adopted gold as its monetary standard.<sup>1</sup> When a country adopts the gold standard, it determines a price for gold in terms of its currency. The country, through its central bank, agrees to buy and sell gold freely at the predetermined rate.<sup>2</sup> The exchange rate is fixed because the government has pledged to convert its currency into gold at that rate. The United States and the other major trading countries in the world operated under fixed exchange rates until the beginning of World War I. Generally, in times of war, nations seek to protect their gold reserves by suspending the convertibility of the domestic currency into gold and forbidding exports of gold.<sup>3</sup> However, the paper currency of one nation may be exchanged for the paper currency of another nation at whatever price is established by the market.<sup>4</sup> The exchange rates become flexible because they are free to seek their own level based upon factors in the market, with little or no government interference.

Following World War I, many nations believed that a return to the gold standard and fixed exchange rates was necessary. Yet, attempts to accomplish this were undermined by the Great Depression and the outbreak of World War II.<sup>5</sup> Flexible exchange rates prevailed as nations sought to protect their gold reserves and economies.<sup>6</sup>

With World War II drawing to a close, the allied nations believed that some form of monetary reconstruction was needed. History had shown that there were serious disadvantages to both fixed and flexible exchange rates. A compromise between the two extremes was neces-

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1. B. COHEN, ORGANIZING THE WORLD'S MONEY 77 (1977).

2. *Id.*

3. *Id.* at 83.

4. *Id.*

5. *Id.* at 85.

6. *Id.* at 85-86.

sary. In 1944, a conference of forty-four allied nations was held at Bretton Woods, New Hampshire, at which time the participating nations developed the Bretton Woods System.<sup>7</sup> These nations agreed to a system of pegged exchange rates in which each country was required to set a par value for its currency and pledge to intervene in the foreign exchange market to limit fluctuations within an acceptable range of par value, to be determined by the participating nations.<sup>8</sup> A country was permitted to alter its par value under certain circumstances, but only if specified procedures were followed.<sup>9</sup> The International Monetary Fund (IMF) was established to assure that member countries had access to an adequate supply of official monetary reserves and to provide a forum for international consultation and cooperation on monetary matters.<sup>10</sup> The United States, as the largest trading nation, was critical to the success or failure of the Bretton Woods System. A stable United States economy was viewed as providing the necessary stability for the system.<sup>11</sup> However, in 1965, inflation, as it gained momentum in the United States, became a destabilizing effect on the system of pegged exchange rates.<sup>12</sup> By 1971, the United States was facing a weakening trade balance and a growing protectionist sentiment in Congress.<sup>13</sup> For these reasons, the government elected to suspend the convertibility of the dollar into gold, thus freeing or unpegging the dollar, and allowing it to find its own level in the exchange market.<sup>14</sup> By 1973, most major trading nations duplicated the action taken by the United States.<sup>15</sup> The Bretton Woods System of pegged exchange rates ended, and an era of flexible exchange rates began and continues to the present time.

A review of the history of exchange rates reveals that fixed rates prevail in times of peace and economic stability, while the outbreak of war or the beginning of major economic uncertainty usually ushers in a period of flexible exchange rates.

### III. BURDEN OF EXCHANGE RATE RISKS

During periods of political and economic stability, a government will be more willing and better able to maintain a fixed or pegged ex-

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7. *Id.* at 90.

8. *Id.* at 91.

9. *Id.*

10. *Id.* at 91, 93.

11. *Id.* at 103.

12. *Id.* at 103-04.

13. *Id.* at 104.

14. *Id.*

15. *Id.* at 109.

change rate. In a system of fixed or pegged exchange rates, the burden of exchange rate risk falls mainly on the government. It is their responsibility to intervene in the foreign exchange market to maintain the established rates. The advantage of fixed or pegged rates is the high predictability of the rate remaining constant, or at least within the accepted range. The only variable is the government's willingness or ability to intervene and keep the rate stable.<sup>16</sup> The major disadvantage is that a government may not be able to maintain the established rate, in which case the probability of a significant one-step change in par value is increased.<sup>17</sup>

In contrast, during times of political or economic crisis, the burden of maintaining a fixed or pegged exchange rate becomes too great to bear, so the currency is set free to find its own level in the foreign exchange market. Under a system of flexible exchange rates, the burden of exchange rate risk falls primarily on the private sector.<sup>18</sup> Market quotations for the currency are based primarily on supply and demand.<sup>19</sup> Rates constantly change with no reliable basis for predicting in which direction or of what magnitude they will move. The primary advantage of flexible rates is that governments do not have to commit resources in order to maintain a fixed or pegged rate system. Market forces are relied upon to determine the long-range value of the currency. A government may intervene in the short-run to eliminate rate aberrations, but the exchange rate will primarily be determined by market forces.<sup>20</sup> The disadvantage is that with the exchange rate constantly fluctuating, there is no way to predict what its value will be at any given point in time.

#### IV. RISKS ASSOCIATED WITH EXCHANGE RATES

There are problems and risks associated with both fixed and flexible exchange rates. However, most business organizations dealing in international transactions believe that flexible exchange rates present the highest level of risk.

Business organizations generally seek to maximize profits while minimizing risk. Flexible exchange rates are perceived as being risky because of the uncertainty as to the direction they are moving and the

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16. S. KATZ, EXCHANGE - RISK UNDER FIXED AND FLEXIBLE EXCHANGE RATES, 83-84 N.Y.U. INST. OF FIN. BULL. 44 (1972).

17. *Id.* at 47.

18. *Id.*

19. *Id.* at 34.

20. *Id.* at 34-35.

potential magnitude of the move. A business enterprise will tend to act in one of two ways when faced with a high risk situation. They will either increase prices to compensate for the high level of risk or they will seek to minimize their exposure by limiting the number of transactions in the high risk area.<sup>21</sup> Either alternative will act as a deterrent to growth in world trade. A price increase to compensate for risk may make a firm uncompetitive in the world market. If risk is perceived as being high, many firms may decide to turn away from the international market entirely.

Flexible exchange rates may also impact the decision-making process of a firm. When a country has a weak currency, international demand for its products is likely to increase. The price of products made in a country with a weak currency will be very attractive to a country with a strong currency. Producers in a country with a weak currency will find a wide range of products profitable to produce and export.<sup>22</sup> While the currency is weak, producers and traders will be enticed to allocate resources to develop foreign markets and expand production capability.<sup>23</sup> If the currency strengthens, these decisions may prove to be unprofitable, but often, once resources are committed, they are not easily reversed or recovered.<sup>24</sup>

The fear of being caught in an unprofitable position due to fluctuations in exchange rates forces businesses to take steps to protect themselves. One reaction to the uncertainties of currency movements is to diversify investment dollars.<sup>25</sup> A firm may identify a country in which production costs would be lower in comparison to the production costs in other countries. However, rather than placing all of its resources in that one country, the firm may seek other countries in which to allocate some of its funds, even if these countries are not as efficient,<sup>26</sup> because the firm may not have the capability of absorbing the costs if all of its resources are allocated to one country and if there is an adverse movement in that particular country's currency exchange rate. By allocating resources to several countries, overall risk actually should decline. An adverse move in one country's exchange rate should be offset by a positive move in the exchange rate of another country. Firms even may attempt to identify currencies which have shown a historical tendency

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21. INTERNATIONAL MONETARY FUND, OCCASIONAL PAPER NO. 28, EXCHANGE RATE VOLATILITY AND WORLD TRADE 3 (July, 1984).

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.* at 4.

26. *Id.*

to move in opposite directions.

A second reaction to uncertainties under flexible exchange rates is to postpone or cancel any long-term commitments.<sup>27</sup> The more volatile exchange rates are, the less attractive a fixed obligation or investment becomes. A company will seek to shorten its decision-making horizons and try to stay as flexible as possible so that it can react quickly to an adverse movement in exchange rates and minimize negative impact on profitability.

Finally, if the uncertainties of flexible exchange rates are perceived as being too great, small firms will be discouraged from entering the arena<sup>28</sup> because they do not have the financial resources to weather periods of unprofitability brought about by an unfavorable move in exchange rates. In addition, they often lack the resources necessary for establishing a program to monitor and evaluate exchange rate risks.

#### V. OPTIONS FOR MANAGING AND MINIMIZING EXCHANGE RATE RISKS

There are many options available to a business organization in order to minimize foreign exchange risk. A company must decide whether the management of the foreign currency position will be centralized at corporate headquarters or decentralized and delegated to the various subsidiaries or groups. Many factors may influence this decision, but most large companies which are heavily involved in foreign transactions tend to select the centralized option.<sup>29</sup> The advantages of a centralized function are that the position of all the subsidiaries can be combined, resulting in certain economies of scale, for the company as a whole,<sup>30</sup> whereas with a decentralized function, local subsidiaries are more concerned about their individual profitability, even if it was detrimental to the company overall. With the centralized function, the company seeks the most economical and advantageous options from anywhere in the world, taking into account any tax impact on the company.<sup>31</sup>

Many of the techniques and options available to manage foreign exchange risks require very technical and specialized knowledge. A central office could assemble a team with the necessary resources and

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27. *Id.*

28. *Id.* at 5.

29. INTERNATIONAL CHAMBER OF COMMERCE, MANAGING EXCHANGE RATE RISKS 23 (1985).

30. A. SHAPIRO, FOREIGN EXCHANGE RISK MANAGEMENT 39 (1978).

31. *Id.*

expertise to carry out its responsibility in the most effective manner. A company would not be able to assemble a quality team at each subsidiary because it would be difficult to find qualified people to go to all the locations, and the costs would be prohibitive.

However, the disadvantage of a centralized function is that the individuals making decisions are not close to the local situation, and are often unaware of subtle changes in a country's political and economic position. A company could overcome this disadvantage by assuring that its central office remain in close contact with all of its foreign subsidiaries and by having the manager of the foreign subsidiary provide the corporate office with his perception of political and economic trends in his location, a forecast of the currency value in the future, and the subsidiary's recommendation concerning the proper course of action.

Business organizations involved in international transactions use various techniques to manage and minimize the risks associated with exchange rates. One of the most simple and commonly used techniques is to specify in the contract that invoices will be prepared and payment will be required in a particular currency.<sup>32</sup> The currency may be the home currency of the seller, the buyer, or of a third unrelated country.<sup>33</sup> The exporter will want to receive payment in a relatively strong and stable currency. Normally, if the home currency of the exporter is relatively strong and stable, it will be the exporter's currency of preference. However, the importer will prefer to pay in its home currency or a currency which is weak against the importer's home currency.

Another technique is to specify in the contract the exchange rate which will be used when payment is made, regardless of what the actual rate is at the time of payment. Variations of this technique would require either a maximum range of exchange rate fluctuations which would be recognized by the parties, or a necessary price adjustment if the exchange rate fluctuates beyond acceptable limits.

A strategy used by sellers is to adjust the credit or payment terms in the contract to reflect the anticipated exchange rate risk. Normally, the exchange rate risk is greater when the period of time between the signing of the contract and payment is longer. To minimize the risk, the seller may shorten the time period allowed for payment, and he may even provide for a prompt payment discount to encourage early payment. In addition, the seller may provide for a penalty if the payment terms of the contract are not met. The penalty serves two pur-

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32. J. HEYWOOD, *FOREIGN EXCHANGE AND THE CORPORATE TREASURER* 29 (2d ed. 1979).

33. *Id.*



poses: first, it encourages the buyer to pay on time, and second, if payment is delayed, it provides for an increased payment which will help to compensate for any adverse movements in the exchange rate. Furthermore, contracts may contain an escalator clause which is geared to the inflation rate of the country of the currency called for in the contract, if that currency is different than the currency of the exporter.<sup>34</sup> This will at least protect the exporter against erosion in value of the currency of payment due to inflation in the country of the currency of payment.

In recent years, a contract clause specifying that a currency basket will be used to establish invoicing terms has gained acceptance.<sup>35</sup> A currency basket is a composite index of currencies of several nations. Each currency is assigned a percentage weight in comparison to the whole.<sup>36</sup> The composite index may serve as a standard of value against which to express an exchange rate for the currency used for invoicing. The advantage of using a currency basket is that it will be less volatile because of the diversification inherent in the calculation of the composite index. Commonly used currency baskets are the International Monetary Fund's Special Drawing Right (SDR) and the European Economic Community's European Currency Unit (ECU).<sup>37</sup> The SDR composite index is composed of the United States dollar, the German Deutschmark, the Japanese yen, the French franc and the British pound sterling.<sup>38</sup> The ECU composite index is composed of the currencies of its member states.<sup>39</sup> The ECU index has been more stable compared to the SDR index in recent years because the highly volatile United States dollar makes up approximately 53% of the SDR composite index.<sup>40</sup>

The ability of a company to obtain a favorable currency clause is dependent upon many factors including its competitive strength, its buying power in a particular market, and its ability to negotiate effectively.<sup>41</sup>

A problem with most contract clauses is that they involve a shifting of risk. A company accepting more risk will demand certain concessions to compensate for the additional risk it has assumed. In a highly competitive market, a company may find that if their competitors are

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34. *Id.* at 31.

35. INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 29, at 17.

36. *Id.*

37. *Id.* at 17-18.

38. *Id.*

39. *Id.*

40. *Id.* at 18.

41. *Id.* at 17.

willing to accept the exchange rate risk, then it also must accept the risk or face a loss of the market share. Some of the concessions which companies will accept in order to affect the exchange rate risk include lower prices or more liberal credit terms. However, the cost associated with these concessions is reduced profits for the company.

While a company may not be in a position to negotiate a contractual clause to shift all or some of the risk to its customers, it may be able to use various financial techniques to manage or minimize the foreign exchange rate risk. Many of these techniques may be utilized without the other party to the transaction having any knowledge of them. There is an added financial cost involved in using these techniques, but such cost is often small compared to the potential losses that may result from a large adverse move in the foreign exchange rates. The impact on the price of a product or service may often be less by utilizing some of these techniques instead of imposing a price increase to offset the anticipated risk absent the use of any protective measures.

Another commonly used technique is for a company to match its receivables and payables in a given currency.<sup>42</sup> This option is often available to a company with a subsidiary or division in the foreign country. If receivables and payables are balanced in a given currency, then generally there is no currency risk. A move in the foreign exchange rate which would create a loss in cash coming in from receivables would be offset by a gain in cash going out in payables. In the opposite situation, a loss in cash going out for payables would be offset by a gain in cash coming in from receivables. In theory, assuming the same currency, if the balance of receivables is equal to the balance of the payables, and cash inflow equals cash outflow, then the risk associated with fluctuations in the foreign exchange rate would be zero. It must be emphasized that in a real world environment, it is virtually impossible to maintain a perfect balance between receivables and payables, and balancing cash inflows and cash outflows is even more difficult. While a company may attempt to influence cash inflow by offering discounts for early payment or penalties for late payments, its ability to impose penalties for late payment may be limited by local laws or the competitive nature of the market. A company generally has more control over its cash outflows, but even here there are limits because a delay in paying obligations may give an organization a negative reputation and hurt its ability to obtain credit.

A variation of the matching technique is to require the foreign

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42. *Id.* at 15.

subsidiary to utilize local currency borrowing to finance working capital.<sup>43</sup> The borrowing would be paid back in receivables collected in the same currency that was borrowed. As in the matching situation, a gain or loss on one side of the transaction would be offset by a corresponding gain or loss on the opposite side of the transaction. By insisting that their foreign subsidiaries or divisions do all buying and selling in the local currency, many multinational corporations view their foreign subsidiaries as domestic companies totally existing within the foreign country.<sup>44</sup> With no immediate need to convert the local currency into another medium of exchange, there is no exchange rate risk. However, the disadvantage of local currency borrowing is that the interest rate in the local country may be much higher than the interest rate in the home country of the foreign subsidiary's parent. If the difference in interest rates is significant, the cost of borrowing may be greater than the perceived risk of foreign exchange rate fluctuations. Another factor to consider is the availability of funds for borrowing in the local currency because in some locations, funds may not be available at any price.

Leading and lagging of receivables and payables is another technique to balance receivables and payables and the timing of cash flows therefrom. Many organizations use the leading and lagging technique to take advantage of swings in foreign exchange rates. If a company is dealing in a currency which it projects will grow significantly stronger in the coming months, then it will attempt to delay the collection of receivables and accelerate the payment of payables.<sup>45</sup> By following this approach, if the currency gains strength, then the currency collected at a future date will have a higher value than it would have had at an earlier date or at the time of invoicing. Yet the currency used to pay off debt at the earlier date will be worth less than it would have been at the later date. A company would be in an enviable position if it could pay out currency with a low value, but receive currency with a high value.

When a company believes that a currency will weaken in the coming months, it will seek to accelerate the collection of receivables and delay the payment of payables.<sup>46</sup> Using this approach, a company can collect currency with a high value, but pay out currency with a low value.

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43. M. DUERR, PROTECTING CORPORATE ASSETS UNDER FLOATING CURRENCIES 24 (1975).

44. *Id.* at 20.

45. SHAPIRO, *supra* note 30, at 29.

46. *Id.*

As with the matching technique, it is difficult to time the receipt and disbursement of cash, when the technique of leading and lagging of receivables and payables is used. In addition, leading and lagging is more speculative than matching. In matching, since inflows equal outflows and receivables equal payables, it really does not matter if the exchange rate moves up or down. A loss on one side will be offset by a gain on the other. The net exposure, due to the matching, will be zero. However, in leading and lagging, the company is taking a position on whether a currency is going to strengthen or weaken. If a company is wrong, it will suffer a loss. For example, if a company anticipates that a currency is strengthening, it would attempt to delay the collection of receivables, but accelerate the payment of payables. If a company miscalculates and the currency weakens, the company will be collecting the currency when its value is less, but paying out the currency when its value is more. If the adverse move in the currency is significant, devastating financial consequences could result.

Another disadvantage of the leading and lagging technique is its impact on cash flow when a company anticipates that a currency is going to strengthen. The delay in collecting receivables and the acceleration of paying payables may drain a company's cash reserves. If a company lacks a strong cash position, it may have to collect receivables in a timely manner and delay the payment of payables as much as possible in order to sustain operations. In this case, a company cannot afford the luxury of leading payables and lagging receivables to take advantage of anticipated movements in foreign exchange rates. Anytime a company delays the collection of cash or accelerates the payment of cash, it incurs an opportunity cost which is the value of the use of money if it were held by the company. In its simplest form, the opportunity cost of money is either the interest that could be earned if the cash were invested or the reduction in interest expense if the cash were used to lower debts.

Large companies with subsidiaries in many foreign locations may use multilateral netting to minimize the foreign exchange rate risk.<sup>47</sup> Multilateral netting is similar to matching; however, instead of matching the receivables and payables of one currency, it mixes several currencies. Each subsidiary or division pays its net base currency to a centralized clearing center. The center then takes the amounts it received to the foreign exchange market. There are two major advantages of this technique. First, because all the currencies, or the net position in the currencies, are brought together in one central location, a company

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47. INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 29, at 16.

is in a better position to evaluate its exposure or risk, and like-currencies from the various subsidiaries or divisions can be netted out. Second, the number of transactions or settlements made in the foreign exchange market can be reduced and this helps to minimize cost. However, the disadvantage of multilateral netting is that it generally is not available to smaller organizations. A company needs a large number of foreign transactions and a variety of currencies to make the technique worthwhile because the costs associated with setting up and maintaining the central clearing center can be significant.<sup>48</sup>

Many business organizations that become involved in international transactions have no contact with the foreign country except for a contract which calls for delivery of goods and services at a future date and payment for the goods and services subsequent to delivery. A company faces the risk of a foreign exchange loss from the moment the contract is signed until final payment is received. Several techniques are available which can be used by those companies with few international transactions as well as those that are constantly involved in international dealings. A common method that can be utilized by any company, regardless of its size or level of activity, is the forward exchange contract which is used when two parties agree to exchange specific amounts of different currencies at a definite future date.<sup>49</sup> The organization locks in the exchange rate at the time the contract is signed.

A slight variation of the forward exchange contract is known as the option-dated forward exchange contract.<sup>50</sup> It permits a party to sell or buy one currency against another by a future date rather than at a definite future date.<sup>51</sup> Although an option-dated forward exchange contract is more costly than a forward exchange contract, it provides more flexibility and is more useful in situations where it is not exactly known when the currency will be required.<sup>52</sup>

Another technique is the use of currency futures or contracts to buy or sell a currency at a future date and at a price fixed when the transaction is consummated.<sup>53</sup> The transactions can only be done by market participants and are restricted to major currencies against the United States dollar.<sup>54</sup> Because the future markets have standard contract amounts and maturities, they are not as flexible as the forward

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48. *Id.*

49. *Id.* at 18.

50. *Id.*

51. *Id.* at 18-19.

52. *Id.* at 19.

53. *Id.* at 20.

54. *Id.*

exchange contract.<sup>55</sup> Future contracts are tradeable, but the market is most active for the shortest contract term, a maximum of three months.<sup>56</sup>

Currency options differ from currency futures in that the holder of the option has the right, but not the obligation, to buy or sell the specific currency at a specific price for a specified period of time.<sup>57</sup> A major advantage of the currency option is that the holder of the option can lock in the price of a currency for a period of time at a known cost. If the option is not required, it expires worthless, with the loss to the holder being equal to what he paid for it. The disadvantage of the option is that it may be costly.<sup>58</sup> The risk in options to the option holder is limited to what he paid for it, known as the premium. The writer of the option assumes an open-ended risk and must be compensated for taking such a risk. The writer's compensation is the premium paid by the holder of the option. The greater the perceived risk is, the higher the premium that will have to be paid to induce someone to write the option.

A business organization that has established sound banking relationships with a bank with foreign branches may make use of currency-collateralized loans. A company places its home currency on deposit with its bank. A foreign branch of that bank then loans an equivalent amount to the foreign subsidiary in the currency of the country in which the foreign subsidiary is located.<sup>59</sup> The bank is assuming the risk of currency fluctuation and will take the proper steps to minimize its own exposure. This technique is especially useful in countries where the capital markets are not well developed or where alternative sources of financing are not available. The disadvantage of this technique is that it is limited to companies which have a sound relationship with a bank that is willing and capable of performing this service for them.<sup>60</sup>

Another technique which has proved useful in limited circumstances is the parallel loan or back-to-back loan.<sup>61</sup> These are similar devices which establish a debt and an agreement to repay the debt, with any interest, in the foreign currency.<sup>62</sup> The parent of a subsidiary would transfer available surplus of its home currency to the subsidiary

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55. *Id.*

56. *Id.*

57. *Id.* at 20.

58. *Id.* at 19.

59. C. BEIDLEMAN, FINANCIAL SWAPS 13 (1985).

60. *Id.*

61. *Id.* at 14.

62. *Id.*

to provide collateral for the loan. A borrower would pay back the loan with cash generated by its subsidiary in the foreign country. This method has limited use because in order for it to work, there must be a match by two parties with excess liquidity in one currency and requirements in another currency for like amounts and periods.<sup>63</sup> The parties must have similar credit standings or else a third party may be required to assume the credit risk of each of the primary parties to the transaction.<sup>64</sup>

If a company has a requirement for currency in a foreign country, it may seek out a company in that foreign country which has a requirement for currency from its home country. The two companies may enter into a currency swap contract<sup>65</sup> which calls for the transfer of currencies between the parties at a specified date and for a reversal of the transfers at a future date.<sup>66</sup> The company with the weaker home currency would pay a fee to entice the other company to enter into the agreement. The fee is meant to compensate for any changes in the exchange rate over the life of the contract.<sup>67</sup>

Foreign exchange rate risk is a significant factor for any company involved in international transactions. Business organizations struggle to maintain their profitability. A gain of a fraction of a percentage point in the bottom line requires countless hours of research and tough decision-making. With all the resources that go into maintaining profitability, it is easy to see why a company is unwilling to go into a foreign transaction unprotected, when currency values can change by 30% or more over a period of a few months or less. A very profitable transaction can turn into a disaster virtually over night if precautions are not taken to minimize foreign exchange risk. The challenge to most business organizations is to obtain an acceptable amount of protection at the lowest possible cost. In highly competitive markets, contracts are won and lost based upon price; therefore, a company must maintain a competitive price for its product or service. One element of maintaining a low price is to eliminate the high level of risk associated with foreign exchange rates in a cost effective manner.

## VI. CASE LAW

Business organizations are not alone in their concern over fluctua-

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63. *Id.* at 14-15.

64. *Id.* at 15.

65. *Id.* at 20.

66. *Id.*

67. *Id.*

tions in the foreign exchange rates. Courts have also considered the impact of movements in the exchange rates. American courts have ruled that any money judgments rendered in the United States must be in American currency.<sup>68</sup> If a contract calls for payment in a foreign currency, but a judgment is awarded by a United States court, then the court must convert the foreign currency judgment into its United States dollar equivalent.

This rule of law was illustrated in *Frontera Transportation Co. v. Abaunza*.<sup>69</sup> The case involved property located in Mexico which was mortgaged to secure a debt for over 86,000 Mexican pesos. The plaintiff was a South Dakota corporation and the defendant was an alien residing in the Eastern District of Louisiana. The plaintiff had paid off the mortgage, except for 42,479.50 pesos, and had tendered \$600 for the principal and interest due. That amount, \$600 in American currency, was the equivalent of 42,479.50 plus interest in Mexican pesos. However, the defendant refused to accept the \$600 in American currency and demanded that payment be made in Mexican currency. The lower court ruled that Frontera was not entitled to tender the equivalent in American money to satisfy the debt and awarded a decree in favor of the defendant for 42,479.50 pesos plus interest.<sup>70</sup>

The United States court of Appeals for the Fifth Circuit agreed that Frontera was not entitled to tender the equivalent in American currency to satisfy the debt.<sup>71</sup> However, it reversed the decree to the extent that it directed the plaintiff to pay the 42,479.50 plus interest in pesos, and on default thereof, awarded an injunction against the plaintiff.<sup>72</sup> In so ruling, the court stated:

The decree is for Mexican pesos, with no finding of their equivalent value in legal tender of the United States. We do not think that the court has the right to render a judgment in Mexican pesos or otherwise than in money of the United States of America. The court should have either found that sum in American money the plaintiff should pay, or should have declined to render a decree for affirmative relief for the defendant, if the proof was not sufficient to enable such a finding to be made.<sup>73</sup>

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68. *Shaw, Savill, Albion & Co., Ltd. v. The Fredrickburg*, 189 F.2d 952, 954 (2d Cir. 1951).

69. 271 F. 199 (5th Cir. 1921).

70. *Id.* at 201-02.

71. *Id.*

72. *Id.* at 202.

73. *Id.*



The requirement that a United States court only render a judgment in United States currency means that the court must use some exchange rate to convert the foreign currency to its United States dollar equivalent. Exchange rates vary daily and moves of 30% or more are not uncommon over the course of a few months or less. In an era of flexible exchange rates, the date selected to determine the equivalent in United States dollars becomes very important.

The issue of which date should be used to convert foreign currency into United States dollars was addressed in three Supreme Court opinions written by Justice Holmes. In *Hicks v. Guinness*,<sup>74</sup> the Court introduced what has become known as the breach day rule. The case involved a debt owed by a German firm to a United States citizen which was due and payable in the United States, in German marks. The District Court converted the German marks to United States currency using the exchange rate on the date of the breach.<sup>75</sup> The decision was affirmed by the Circuit Court of Appeals.<sup>76</sup> In agreeing with the lower courts, the Supreme Court stated:

The loss of which the plaintiff is entitled to be indemnified is 'the loss of what the contractee would have had if the contract had been performed,' *Chicago, Milwaukee & St. Paul Rv. Co. v. McCaull-Dinsmore Co.*, 253 U.S. 97, 100; it happens at the moment when the contract is broken, just as it does when a tort is committed, and the plaintiff's claim is for the amount of that loss valued in money at that time.<sup>77</sup>

One year later, in *Deutsche Bank Filiale Nurnberg v. Humphrey*,<sup>78</sup> the Court held that the proper date for determining the exchange rate is at the time of judgment.<sup>79</sup> This rule became known as the judgment day rule. The case involved a United States citizen who deposited money in a German bank located in Germany. The American attempted to withdraw the funds which would have been in German marks. The bank refused to release the funds and the American brought suit against the bank. The lower courts held for the plaintiff and followed the breach day rule of *Hicks* in converting the judgment into United States dollars based on the rate of exchange existing when

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74. 269 U.S. 71 (1925).

75. *Id.* at 79.

76. *Id.*

77. *Id.* at 80.

78. 272 U.S. 517 (1926).

79. *Id.* at 518.

demand for the money was made by the plaintiff, but refused by the defendant.<sup>80</sup>

The Supreme Court in reversing the lower court stated:

[A]t the date of demand the German bank owed no duty to the plaintiff under our law. It was not subject to our jurisdiction and the only liability that it incurred by its failure to pay was that which the German law might impose. . . . We may assume that when the bank failed to pay on demand its liability was fixed at a certain number of marks both by the terms of the contract and by the German law — but we also assume that it was fixed in marks only, not at the extrinsic value that those marks then had in commodities or in the currency of another country.<sup>81</sup>

Furthermore, the Court noted that the obligation, in terms of the currency of payment, is subject to currency fluctuations, but that the law does not consider whether the creditor or debtor profits by such fluctuations.<sup>82</sup> In addition, the Court emphasized that a foreign debtor should be accorded the same treatment as a domestic debtor in the sense that if the debt had been a domestic one, and the value of the dollar had dropped before suit was brought, the domestic plaintiff would not recover more dollars because of the drop in value.<sup>83</sup>

In *Deutsche Bank*, the marks were converted at the exchange rate on the date that the judgment was awarded. However, the obligation, as to a fixed number of marks due, was determined from when demand was made. A change in exchange rate values between the time when demand was made and a judgment was awarded would not alter the liability as far as the specific number of marks due. Yet, the value of the obligation in United States currency would differ depending on the movement of the exchange rate between the time of demand and the time of judgment. In this instance the mark depreciated in value between the time demand was made and the judgment was rendered.<sup>84</sup> The conversion from marks to dollars at the time judgment was rendered produced a smaller award in terms of United States currency than a conversion from marks to dollars at the time of breach.

The following example will illustrate the potential impact of selecting the date of judgment rather than the date of breach to convert

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80. *Id.*

81. *Id.* at 518-19.

82. *Id.* at 519, *citing* LEGAL TENDER CASES 12 Wall. 457, 548-49.

83. *Id.* at 519.

84. *Id.* at 518.

from marks to dollars at a time when the mark is depreciating in value.

Amount of marks in German bank at the date demand was made by the plaintiff: 100,000.

Exchange rate at the time of demand: .44 (mark/dollar).

Exchange rate at the time of judgment: .40 (mark/dollar).

U.S. dollar equivalent at the time of demand: \$44,000 (100,000\*.44).

U.S. dollar equivalent at the time of judgment: \$40,000 (100,000\*.40).

Decrease in U.S. dollar value from the time of breach to the time of judgment: \$4,000 (\$44,000 - \$40,000).

The example shows the potential importance of which date the court selects to convert the foreign currency into the equivalent United States currency. The more volatile the exchange market is, the more important the selection of the date for calculating the United States dollar value of the judgment.

The apparent contradiction between *Hicks* and *Deutsche Bank* was addressed by Justice Holmes in *Zimmermann v. Sutherland*.<sup>85</sup> The case involved a debt which was due and payable in a foreign country, in the currency of that foreign country. The lower court applied the judgment day rule.<sup>86</sup> The Supreme Court stated:

The decision of the circuit court of appeals was right and in view of the recent case of *Deutsche Bank Filiale Nurnberg v. Humphrey*, 272 U.S. 517, does not need extended reasoning. Here, as there, the debt was due and payable in the foreign country. The only primary obligation was that created by the law of Austria-Hungary, and if by reason of an attachment of property or otherwise the courts of the United States also gave a remedy, the only thing that they could do with justice was to enforce the obligation as it stood, not to substitute something else that seemed to them about fair. The distinction between the *Deutsche Bank Filiale Nurnberg* case and *Hicks v. Guinness*, 269 U.S. 71, is not, as argued, that the plaintiff

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85. 274 U.S. 253 (1927).

86. *Id.* at 255.

in *Hicks v. Guinness* was in the United States, but that, as the court understood the facts, the debt was payable in New York and subject to American law, so that upon a breach of the contract there arose a present liability in dollars.<sup>87</sup>

The rule of law that emerges from *Zimmerman* is that when an obligation is payable in a foreign currency in a foreign country, then the judgment day rule will apply. If the obligation is payable in a foreign currency in the United States, then the breach day rule will apply.

The rule of law laid down in *Zimmerman* was extended to tort obligations in *Shaw, Savill, Albion & Co., Ltd. v. The Fredricksburg*.<sup>88</sup> The case involved damages arising from a collision between an American owned ship and a British owned ship in British territorial waters. The American company agreed to pay damages to the British company. The court applied the judgment day rule in converting the judgment into United States currency, and noted:

In 40 HARVARD L. REV. (1927) 619, 625 it is said: 'Upon the commission of a tort a right arises to damages, expressed in units of the money of the country in which the tort occurred. These damages, primarily expressed in the money of the foreign country, should be translated into money of the forum as of the date when the right is merged in a forum judgment. Conversely, where a tort occurs in the forum, but where damages must be reckoned in terms of foreign money, the right to reparation is expressed in the money of the forum at the date the cause of action arises, and hence the rate of exchange existing on such date should prevail.' With that statement we agree.<sup>89</sup>

Therefore, if the tort occurs in a foreign country, and damages are payable in foreign currency, then the judgment day rule will be applied. Conversely, if the tort occurs in the United States, and damages are payable in a foreign currency, then the breach day rule will apply.

The decisions in *Hicks* and *Deutsche Bank* resulted in courts applying two different formulas for determining when to apply the breach day or judgment day rules. The two approaches were discussed in *In re Good Hope Chemical Corporation*.<sup>90</sup> The court explained:

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87. *Id.* at 255-56.

88. 189 F.2d 952 (2d Cir. 1951).

89. *Id.* at 955.

90. 747 F.2d 806 (1st Cir. 1984), *cert. denied*, 105 U.S. 2328 (1985).

Two principal approaches have emerged. The first is a rather mechanical approach that focuses on the place of payment. It requires that the judgment day rule apply when the contractual obligation is payable in a foreign country in that country's currency, and the breach day rule apply when the payment is to be made in the United States.<sup>91</sup>

The court in *In re Good Hope* articulated a second approach which it believed conformed more closely with the rules of law laid down in *Hicks* and *Deutsche Bank*. It stated:

This approach looks to the jurisdiction in which the plaintiff's cause of action arose to determine which rule is applicable. The judgment day rule applies only when the obligation arises entirely under foreign law. If, however, at the time of breach the plaintiff has a cause of action arising in this country under American law, the breach day rule applies.<sup>92</sup>

The court believed that the weight of authority endorsed a jurisdictional approach.<sup>93</sup> The court stated:

In this case, the bankruptcy court and the parties were in agreement that Good Hope's cause of action arose under American law. The 'choice of law' approach mandates, therefore, that the rate of exchange in effect on the breach date prevail.<sup>94</sup>

Since a United States court will not award a judgment in a foreign currency, the court will convert the foreign currency to United States currency based on the exchange rate at either the date of breach or the date of judgment. In most cases the exchange rate is known or easily obtainable. In cases where the exchange rate is not known or is not easily obtainable, the issue of who has the burden of proof to show that a foreign currency has a certain value in the United States must be decided. This issue was addressed in *Tillman v. Russo Asiatic Bank*.<sup>95</sup> The plaintiff sued a Russian bank, located in Russia, for failing to pay a check he had written, calling for payment in rubles. The court applied the judgment day rule because the debt was due in a foreign

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91. *Id.* at 810.

92. *Id.* at 811.

93. *Id.*

94. *Id.* at 812.

95. 51 F.2d 1023 (2d Cir. 1931).

country, payable in currency of that country.<sup>96</sup> However, the plaintiff failed to establish the bank's obligation in Russian rubles and neglected to show that rubles had any value in the United States at the date of judgment.<sup>97</sup> The court explained:

The plaintiff should have produced the decrees and proved their contracts, if it sought to establish that the claims having a value, nominal at the time, were made payable in a new currency worth 53 cents per ruble. It had the burden of proving the value of the rubles in United States currency at the date of judgment. That burden it has not sustained.<sup>98</sup>

In addition to the burden of proof issue, courts have been faced with the issue of determining which exchange rate to use when there is more than one exchange rate in existence on the date selected for converting foreign currency into its equivalent United States currency. This issue was addressed in *Trinh v. Citibank, N.A.*<sup>99</sup> In *Trinh*, the plaintiff brought an action against Citibank in New York to receive 3,000,000 piasters deposited by his father in a joint account in the Saigon branch of Citibank. The Saigon branch closed prior to the fall of the South Vietnamese government. The plaintiff's father had mailed the passbook to the plaintiff in the United States and expressed his desire that the plaintiff use the money for personal and educational expenses. The plaintiff contacted Citibank in New York and was told that the National Bank of Vietnam was now responsible for the deposit. The plaintiff filed suit to seek the return of the deposits from Citibank. The court held for the plaintiff, stating that the home office of a branch bank is liable on the deposit made in one of its foreign branches when that branch wrongfully fails to return the deposit.<sup>100</sup> Using the breach day rule, the court also held that the South Vietnamese currency should be converted to United States dollars at the time demand was made to return the deposits.<sup>101</sup> The court reasoned that when the Saigon branch closed, the obligation shifted back to New York. When demand was made, the obligation was payable in foreign currency in the United States; therefore, the breach day rule

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96. *Id.* at 1025.

97. *Id.*

98. *Id.* at 1026.

99. 623 F. Supp. 1526 (E.D. Mich. 1985).

100. *Id.* at 1529, citing *Sokoloff v. National City Bank*, 239 N.Y. 158, 145 N.E. 917 (1924).

101. *Id.* at 1537.

applied. Once the court determined that the plaintiff could recover the deposits and that the proper date for conversion was the date of the breach, it then faced the problem of which exchange rate, existing on the date of the breach, would be used.

The piaster was replaced by the South Vietnamese dong in September of 1975.<sup>102</sup> The South Vietnamese dong was replaced by the Vietnamese dong in May of 1978.<sup>103</sup> The piaster was a blocked currency when it was in existence, and it is currently illegal to trade in the Vietnamese dong.<sup>104</sup>

The plaintiff requested the court to use the effective rate of exchange in November of 1980, which was shown to be 2.39 Vietnamese dongs to the United States dollar.<sup>105</sup> Yet, the defendant argued that the court should use the unofficial market rate, which was 17 Vietnamese dongs to the United States dollar.<sup>106</sup> In selecting the unofficial market rate, the court explained:

Courts have refused to look at official rates of exchange when currencies are blocked or when the official rate otherwise does not apply to the transaction at hand. See *Hughes Tool Co. v. United Artist Corp.*, 279 App. Div. 417, 110 N.Y.S.2d 383 (1952), *aff'd* 304 N.Y. 942, 110 N.E.2d 884 (1953). *Cinelli v. CIR*, 502 F.2d 695 (6th Cir. 1974). Courts instead seek to apply commercial rates of exchange that reflect actual fair market value of foreign currency.<sup>107</sup>

In summary, a United States court may not render a judgment in foreign currency. Obligations in foreign currency must be converted to United States dollars. The exchange rate used to make the conversion will be either the exchange rate on the date of the breach (breach day rule), or the exchange rate on the date of the judgment (judgment day rule). The breach day rule is used when the obligation to pay foreign currency arises in the United States. The judgment day rule is applied when the obligation to pay foreign currency arises in that foreign country. The plaintiff bears the burden of showing that a foreign currency has a particular value in the United States. Courts prefer commercial rates of exchange that reflect the actual fair market value of the for-

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102. *Id.* at 1536.

103. *Id.*

104. *Id.*

105. *Id.* at 1537-38.

106. *Id.* at 1538.

107. *Id.*

eign currency rather than official rates of exchange which may or may not be related to the fair market value of the currency.

#### VII. CONCLUSION

Foreign exchange rates have been a significant factor in international business transactions and in court decisions. Exchange rates will continue to be an important factor in both of these areas as long as they continue to fluctuate and do not become stagnant. Business organizations must continue to consider how to manage and minimize exchange rate risks, and courts must consider the legal issues associated with fluctuating exchange rates.

*Edward Jackson*



