Winter 1988

International Debt and the Act of State Doctrine: Judicial Abstention Reconsidered

W. H. Knight Jr.

Follow this and additional works at: http://scholarship.law.unc.edu/ncilj

Part of the Commercial Law Commons, and the International Law Commons

Recommended Citation


Available at: http://scholarship.law.unc.edu/ncilj/vol13/iss1/5

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Journal of International Law and Commercial Regulation by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
International Debt and the Act of State Doctrine: Judicial Abstention Reconsidered

W.H. Knight, Jr.*

Professor Knight examines the act of the state doctrine as it affects repudiation of loans made to foreign governments. Professor Knight concludes that judicial abstention based on the act of state doctrine is itself a statement of foreign policy, despite the judiciary's repeated assertion that the purpose of the doctrine is to remove the judiciary from international politics. Professor Knight argues that U.S. courts should abstain from rendering judgment in cases involving dept repudiation by foreign governments only if the executive branch is currently involved in settling the disputes arising from the repudiation. Professor Knight further argues that the executive branch has an affirmative duty, under federal banking law, to intervene in such dept disputes, and that the judiciary should recognize a power to require the executive branch to act.

Loan default is every banker's nightmare; debt repudiation is simply unthinkable. Yet, for most U.S. bankers who deal in multinational lending, the unthinkable is perilously close to becoming a reality. Recent additions by banks to their loan loss reserves represent admissions that they do not reasonably expect to recover money loaned to foreign governments, particularly those in Central and South America.¹ Bank acknowledgment that portions of sovereign debt are expected to be lost may set the stage for a real and immediate crisis.

To date, sovereign risk lending has been considered a purely private enterprise that required individual banks to bear the consequences of international loans which turned sour. There is substance, however, to bank pleas for federal assistance in managing sovereign loans. The failure of one or two multinational banking in-

* Associate Professor of Law, University of Iowa. B.A., University of North Carolina at Chapel Hill; J.D., Columbia University. Patrick Bauaer, Tracey Burton, William Buss, Jonathan Carlson, Malvina Halberstam, Frederick Hart, Susan Mask, Richard Matasar, Barry Matsumoto, Kim Sorrells, David Vernon, Burns Weston, Gregory Williams and Peter Winship all made incisive, detailed, and appreciated criticisms, some of which I unwisely ignored.

¹ See, e.g., Chase Joins Banks Taking Loan Loss-Like Citicorp, It Acknowledges Third World Debt Problem, N.Y. Times, May 28, 1987, at 1, col. 3. BankAmerica Raising Reserve $1 Billion; Manufacturers Hanover Mulls Similar Step, Wall St. J., June 9, 1987, at 3, col. 1. More Big Banks Boost Reserves on Loan Woes, Wall St. J., June 12, 1987, at 2, col. 2. It should be noted that money-center banks were not the only institutions to have encountered problems with sovereign loans. Major regional banks also announced increases to loan-loss reserves. See also Norwest To Raise Loan-Loss Reserve By $200 Million, Wall St. J., May 27, 1987, at 2, col. 3.
stitutions could jeopardize the entire U.S. banking system and thus threaten the nation's economic stability. Protecting institutional lenders from sovereign default is therefore in the nation's best interest. This important national interest can be secured only through the combined efforts of the judicial and executive branches of government. Achieving the necessary protection will require a reinterpretation of the act of state doctrine (act of state or doctrine).²

Act of state prohibits U.S. courts from inquiring into the validity of public acts by a recognized foreign sovereign when the acts in question occur within that country's own territory.³ Much has been written about act of state in the context of its effect on the judiciary's ability to provide redress to parties claiming injury by expropriation.⁴ While less has been written about the doctrine's application in cases of foreign sovereign debt, there is a developing body of comment.⁵ Recent commentary addresses the issue of what options U.S. lending institutions face in the event a debtor nation defaults⁶ on or actually repudiates⁷ its loan obligations.

Under conventional interpretations of act of state, the doctrine would require courts to apply a foreign state's law without considering whether that law violates either U.S. or international law. A

² Debt restructuring remains a primary concern of contract law which cannot be regulated effectively. Consequently, this paper takes the position that congressional participation in sovereign debt negotiations would not be helpful.
³ Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 428 (1964). See generally Restatement of United States Foreign Relations Law (Revised) § 469 comments a-c, reporter's note I (Tent. Draft No. 7, 1986). However, the sovereign is obligated to pay just compensation for its takings under principles of international law. Id. § 712.
⁶ The term default may be somewhat misleading. Technically, default occurs whenever there is a failure to perform a legal duty. In the case of lending, default could be found to have occurred through the failure to pay principal or interest on a debt. Under that definition, many debtor nations arguably have already defaulted by failing to make any principal payments for extended periods of time. Many countries have incurred additional debt to enable them to pay the interest on previously established obligations. Such a practice is unsound policy for both creditor and debtor.
⁷ Repudiation would involve a nation's public authorities refusing to acknowledge or pay a debt. It is not a new development in international lending. See, e.g., Miller v. National City Bank, 166 F.2d 723 (2d Cir. 1948) (Russian repudiation of foreign debt incurred by Czar).
debtor nation’s nonpayment of its loan obligations would be considered a sovereign act not subject to judicial questioning based on U.S. contract and debtor-creditor law. By the very act of nonpayment, a debtor nation already would have indicated what it believed to be the legally appropriate measure. The consequences of nonpayment thus would have to be resolved without the benefit of the very law that the parties agreed should govern. Additionally, there are no apparent directives that compel intervention by either Congress or the Executive. Furthermore, suit in the International Court of Justice would be unlikely because all parties must consent to the Court’s jurisdiction. It is quite improbable that a debtor nation would agree to have any outside court evaluate its decisions involving sovereign debt. In effect, act of state deprives an aggrieved lender of both the agreed-upon governing forum and any real likelihood of success in recovering a judgment against a nonpaying sovereign debtor.

Act of state is not a political question problem because its application does not result in case dismissal. The effect of applying foreign law to a sovereign expropriation, however, yields a result that is quite similar to judicial abstention in political question cases. Because any expropriation is a delicate political issue, courts have used the doctrine as a means of abstaining. The doctrine presupposes the existence of certain conditions before a court can refuse review. Unfortunately, those conditions have not been clearly established. The underlying bases for the principle, coupled with the mechanical rules used to apply or except the doctrine, have led to particular confusion in cases involving intangible property like sovereign debt.

This article suggests that the conventional judicial approach to foreign expropriation be reconsidered in cases involving sovereign risk loans. The U.S. courts provide the only forum for effective redress of international debt problems and should remain open to the claims of U.S. lender banks. Some courts have construed act of state to create an absolute bar to review while other courts have developed exceptions to the doctrine which permit sovereign debt repayment disputes to be adjudicated under U.S. law. By examining the philosophical underpinnings of act of state cases, it will be argued that in cases involving sovereign debt, current analytical approaches to the doctrine focus on the wrong sovereign. Judicial review should be directed toward examining the actions of the U.S. executive branch rather than those of the foreign debtor nation. Contrary to

\textsuperscript{8} It is customary in contract drafting and loan documentation that the choice of law will be a jurisdiction known and likely favorable to the lender. See generally Peterson, \textit{Conflict Avoidance Through Choice of Law and Forum}, in \textit{Drafting Contracts and Commercial Instruments} 158, 163-65 (Research and Documentation Corp. 1971) (discussing and providing examples of choice-of-law clauses in international agreements).

\textsuperscript{9} For lack of a better term, this paper uses the word “abstention” to refer to court decisions to refuse review under principles of U.S. law.
its stated goal, judicial abstention does not shelter courts from helping to create foreign policy in a haphazard manner.

A reformulated act of state theory would continue to presume that the executive branch is, constitutionally, the appropriate branch to develop and carry out U.S. foreign policy. The doctrine reconsidered, for the first time, would recognize that implicit in the prohibition is an expectation that the executive branch is acting to resolve debt disputes which affect foreign affairs. Thus, the essence of act of state should be that courts should refrain from acting only when the executive is already involved in debt disputes.

In cases of foreign sovereign debt, the executive's involvement has been less than stalwart. Pragmatically, loan default or debt repudiation by a sovereign is of such national importance that the executive should act. In many instances, however, the administration has shunned participation in these so-called "private" commercial affairs. This article argues that executive intervention in the sovereign debt crisis is a duty expressly required under federal banking law.

The Federal Deposit Insurance Corporation was created under the Banking Act of 1933 to protect bank depositors, to maintain public confidence in the banking system, and to promote safe and sound banking practices.\textsuperscript{10} By linking executive action to federal legislation, the primary obstacle confronting judicial review—executive discretion—is overcome. Because Congress has directed the executive to maintain public confidence in banks by promoting safe and sound operations, the executive's inaction in foreign sovereign debt problems arguably violates a legislatively-prescribed duty. Where the executive fails to meet its duties, courts have the power to order mediation on behalf of private commercial banks, despite act of state's apparent prohibition.

This article is divided into three parts. Part one describes the historical development of the act of state doctrine and demonstrates that the judiciary has misconceived the doctrine by interpreting it to preclude any judicial action when a foreign sovereign commits an act of expropriation. This part will explore the tension between abstention and the court's role as arbiter. Part two examines the international debt problem\textsuperscript{11} and suggests why act of state's mechanical


\textsuperscript{11} See generally Goldstein, The Continuing World Debt Crisis, 3 INT'L TAX & BUS. L. W. 119 (1983) (discussing the causes and the magnitude of the world debt). The total debt of the less developed countries (LDCs) was around $700 billion in 1983. Johnson, International Bank Lending After the Slowdown, THE BANKER 26 (Jan. 1984), reprinted in id. at 131; see also WORLD BANK, WORLD DEBT TABLES (1987).
principles of territoriality do not address the issues created by sovereign lending. This section argues that loan repayment difficulties are matters of national concern and that the executive branch is a necessary party in any dispute between a U.S. lender and a sovereign debtor. It also explores the constitutional underpinnings of the doctrine as it relates to sovereign debt. Finally, part three argues for judicial activism by reviewing the banking concept of safety and soundness and contending that in cases of sovereign debt, federal banking law requires executive intervention.

I. Development of the Act of State Doctrine

The doctrine was first articulated by a British court in *Blad v. Bamfield*, in which the defendant, acting under the authority of the King of Denmark, appropriated property of British citizens living in Iceland. The court refused to rule on the validity of the foreign confiscatory acts, thus precluding suit by the defendant in England.

The U.S. Supreme Court first articulated a policy of judicial noninvolvement in 1808 in the case of *Hudson v. Guestier*, which involved the seizure by the French of a U.S.-owned vessel. The ship was taken to a Cuban port and condemned by a French court sitting in Guadeloupe. Chief Justice Marshall found French jurisdiction was proper, and concluded that since the vessel was in the lawful possession of a foreign sovereign, "no foreign court is at liberty to question the correctness of what is done."

Almost ninety years after *Hudson*, the philosophical basis for the act of state doctrine was stated in *Underhill v. Hernandez*: international comity required judicial restraint. Comity is a principle of courtesy, not of law, by which one nation recognizes the governmental acts of another nation and defers to that country's jurisdiction.

---

12 Rule 19(a) of the federal rules of civil procedure provides in part:

A person . . . shall be joined as a party in the action if (1) in his absence complete relief cannot be accorded among those already parties, or (2) he claims an interest relating to the subject of the action and is so situated that the disposition of the action in his absence may (i) as a practical matter impair or impede his ability to protect that interest or (ii) leave any of the persons already parties subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations . . . . If he has not been so joined, the court shall order that he be made a party.

FED. R. CIV. P. 19.

13 36 Eng. Rep. 992, 993 (Ch. 1674).

14 *Id.*

15 8 U.S. (4 Cranch) 293 (1808).

16 *Id.* at 294. It is uncertain whether the court's holding was based upon principles of personal jurisdiction, rules of admiralty, or substantive law. *Hudson* has been viewed subsequently as a principle of substantive law.

17 168 U.S. 250, 252 (1897).

18 In Hilton v. Guyot, 159 U.S. 113, 163-64 (1895), the Supreme Court stated that comity required a balancing of international duty and convenience with rights and interests of American citizens. Comity also lay at the foundation of U.S. domestic law of personal jurisdiction during
In *Underhill*, a U.S. citizen operated a waterworks and machinery repair business in Venezuela. After the 1892 revolution, Underhill was refused a passport by General Hernandez, the new civil and military chief of the area. Underhill alleged that he was under house arrest and that he had been assaulted by Hernandez's soldiers. When finally permitted to leave the country, Underhill brought suit in the United States against Hernandez for damages sustained during his detention. The Supreme Court affirmed the lower court's decision denying Underhill recovery. Writing for the Court, Chief Justice Fuller noted that:

'[e]very sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory. Redress of grievances by reason of such acts must be obtained through the means open to be availed of by sovereign powers as between themselves.\(^\text{19}\) Hernandez's acts were equated with those of the Venezuelan government, and as such were not justiciable in a U.S. court.\(^\text{20}\)

During the first half of the twentieth century, there were a number of courts which accepted *Underhill*'s sovereignty rationale as a basis for act of state. Some courts invoked the doctrine despite judicial questions concerning the validity of foreign government confiscatory decrees.\(^\text{21}\) Other courts, uncomfortable with the doctrine, sought ways to avoid the prohibition. By precluding judicial review, the doctrine failed to recognize the possibility of concurrent claims

---

\(^{19}\) 186 U.S. at 252.

\(^{20}\) The Supreme Court again enunciated this theme in *Oetjen v. Central Leather Co.*, 246 U.S. 297 (1918). In that case, the plaintiff-assignee of a Mexican hide merchant sought to recover hides that had been confiscated by a general in the Mexican army and sold to the defendant. Plaintiff claimed that confiscation violated international law prohibiting the taking of private property under article 46 of the 1907 Hague Convention, 36 Stat. 2277, 2306-07 T.S. No. 539 (1907). In denying recovery, the Court held:

The principle that the conduct of one independent government cannot be successfully questioned in the courts of another . . . rests upon the highest considerations of international comity and expediency. To permit the validity of the acts of one sovereign state to be re-examined and perhaps condemned by the courts of another would very certainly "imperil the amicable relations between governments and vex the peace of nations." . . . The remedy of the former owner, or of the purchaser from him, of the property in controversy, if either has any remedy, must be found in the courts of Mexico or through the diplomatic agencies of the political department of our government.

246 U.S. at 303-04.

to jurisdiction. Why should a U.S. court, which had a legitimate interest in hearing a case, defer to a foreign state's acts of expropriation? The result was to give greater effect to foreign rather than domestic law in act of state controversies.

The Court of Appeals for the Second Circuit established the first exception to the doctrine's abstention principle in *Bernstein v. Nederlandsche-Amerikaansche Stoomvart Maatschappij* which came to be called the "*Bernstein* Letter Exception." The plaintiff sought to recover two ships expropriated by the German Government during World War II. At the time of the suit, the ships were under the control of Nederlandsche, a Dutch corporation. The Second Circuit affirmed the part of the district court's holding that the act of state doctrine precluded judicial inquiry into the validity of the German Government's actions.

Two months after the court of appeals decision, the U.S. State Department issued a "general interest" press release which stated that the executive branch did not object to the exercise of jurisdiction by U.S. courts in suits involving property expropriated by the German Government. On rehearing, the court cited the press release and allowed the district court to consider this claim. The *Bernstein* court's turnaround complicated the act of state concept by giving the judiciary an alternative to abstention. Still, the court of appeals' treatment of the State Department letter raised questions concerning the separation of powers principle and the court's independence to decide whether to hear a case. Specifically, would judicial review be linked to approval from another branch of government?

The *Bernstein* decision raised questions about the very basis of the act of state doctrine. Assuming it were proper to hear an expropriation case when the executive branch stated that foreign policy would not be affected by a hearing, the reviewing court need not presume that executive silence means a court should refrain from hearing a case. Despite a court's ability to request executive briefings on foreign policy, or to consider pertinent treaties and legislative history, the question of justiciability is and should be a decision for the court alone.

The Supreme Court has refused to address the continuing valid-

---

22 173 F.2d 71 (2d Cir. 1949).
23 *Id.* at 78.
24 See *Jurisdiction of the United States Courts for Identifiable Property Involved in Nazi Forced Transfers*, 20 DEP'T ST. BULL. 592, 593 (1949).
25 210 F.2d 375 (2d Cir. 1954).
ity of the Bernstein exception\textsuperscript{27} and, not surprisingly, "Bernstein Letters" have influenced the result in several subsequent cases.\textsuperscript{28}

\textbf{A. Act of State Reconsidered: Sabbatino}

During its 1964 term, the Supreme Court reviewed the act of state concept. This time, however, the Court articulated a different rationale for the doctrine than that found in Underhill; namely, that the judiciary's limited competence in this area found its basis in the constitutional principle of separation of powers.\textsuperscript{29}

In \textit{Sabbatino},\textsuperscript{30} the Cuban Government expropriated property of the Compania Azucarera Veritenties-Camaguey de Cuba (CAV). CAV agreed to sell sugar to a U.S. commodity broker, Farr Whitlock & Co. (Farr). Under the sales agreement, Farr was to pay for the sugar upon presentation of a sight draft and a bill of lading in New York. On the day that CAV's sugar was being loaded in Havana, the Cuban government, which had nationalized all property in which U.S. nationals held an interest, expropriated all of CAV's property. The expropriation decree declared that no boats could leave the harbor without permission from the new government. The decree amounted to government blackmail; in order to obtain permission to leave Cuban waters, Farr was required to enter new contracts with a quasi-governmental agency which were identical to those already executed between Farr and CAV. The Cuban agency then assigned the bills of lading to Banco Nacional which tendered the documents to Farr's New York bank. Farr refused to pay Banco Nacional, claiming that it had previously paid CAV. Banco Nacional brought suit to recover the money allegedly due under the bill of lading.

The Court was faced with the issue of whether the act of state

---

\textsuperscript{27} But see First National City Bank v. Banco Nacional de Cuba, 406 U.S. 759 (1972), and discussion infra notes 43-55 and accompanying text.


\textsuperscript{29} We do not believe that this doctrine is compelled either by the inherent nature of sovereign authority, . . . or by some principle of international law . . . .

Despite the broad statement in \textit{Oetjen} that "The conduct of the foreign relations of our government is committed by the Constitution to the Executive and Legislative . . . Departments," . . . it cannot of course be thought that "every case or controversy which touches foreign relations lies beyond judicial cognizance." . . . The text of the Constitution does not require the act of state doctrine; it does not irrevocably remove from the judiciary the capacity to review the validity of foreign acts of state.

The act of state doctrine does, however, have "constitutional" underpinnings. It arises out of the basic relationships between branches of government in a system of separation of powers. It concerns the competency of dissimilar institutions to make and implement particular kinds of decisions in the area of international relations.


\textsuperscript{30} Id.
doctrine applied to sovereign acts considered by the United States to be in violation of international law.\textsuperscript{31} Citing Bernstein, Farr argued that the doctrine applied only at the executive branch's specific suggestion and was not available in instances where a foreign government was plaintiff in a U.S. court.\textsuperscript{32} The Supreme Court rejected the argument and held that the act of state doctrine barred U.S. courts from examining the claim. Judicial review would require a decision on the validity of Cuba's expropriation decree. The executive, as opposed to the judiciary, was better equipped to address the ramifications of a sovereign taking. Justice Harlan's opinion noted several factors that would enable the executive to act more effectively: the administration's ability to award discretionary foreign aid, the encouragement of private American investment, the possibility of economic sanctions, and the freezing of foreign assets in the United States.\textsuperscript{33} Justice Harlan also noted, "If the political branches are unwilling to exercise their ample powers to effect compensation, this reflects a judgment of the national interest which the judiciary would be ill-advised to undermine indirectly."\textsuperscript{34}

The Sabbatino decision now required courts to consider the extent to which a foreign sovereign could be offended by judicial intervention. International comity as well as the constitutional principle of separation of powers had to be factored into the decision to grant review. If an expropriation had consequences which extended beyond the sovereign's relationships in the United States, act of state compelled restraint. Since nearly all sovereign takings have extraterritorial effects, Sabbatino has been interpreted as stating a doctrine of compulsory judicial abstention.\textsuperscript{35} Although some courts have applied the doctrine strictly,\textsuperscript{36} absolute abstention has not occurred. Rather, many courts have been unwilling to accept Sabbatino's re-

\textsuperscript{31} The district court found the doctrine inapplicable on the basis that the expropriation decree violated international law because the action: 1) was motivated by a retaliatory and not a public purpose; 2) discriminated against U.S. citizens unfairly; and, 3) did not provide any stated method of compensation for losses. 193 F. Supp. 375, 384-85 (S.D.N.Y. 1961). There are relatively few nations that do not consider acts of expropriation to be against international law. See 376 U.S. at 428 n.26.

\textsuperscript{32} 376 U.S. at 420.

\textsuperscript{33} Id. at 428.

\textsuperscript{34} Id. at 435-36.


\textsuperscript{36} See, e.g., International Ass'n of Machinists & Aerospace Workers v. OPEC, 649 F.2d 1354 (9th Cir. 1981), cert. denied, 454 U.S. 1163 (1982); Hunt v. Mobil Oil Corp., 550 F.2d 68 (2d Cir.), cert. denied, 434 U.S. 984 (1977). See also, Note, Judicial Balancing of Foreign
quired forbearance. As will be seen, additional exceptions to the doctrine were developed.

B. Act of State Exceptions

1. The Hickenlooper Amendment

Congress, unhappy with the result in Sabbatino, responded to the decision by enacting the Hickenlooper Amendment to the Foreign Assistance Act. Specifically, the Amendment was intended to avoid Sabbatino by requiring U.S. courts to apply principles of international law to determine sovereign expropriation cases on the merits, unless the President requests that no such determination be made. Unfortunately, the law was unclear as to how international law principles would be either identified or utilized in expropriation cases. Like Bernstein, the Hickenlooper Amendment did not address the perception of a separation of powers conflict. While legislative or executive input might not contravene the separation of powers principle, the language in Bernstein and the Hickenlooper Amendment encouraged courts to rely excessively upon executive pronouncements regarding a case's justiciability. Act of state, however, is foremost a judicial decision and the appearance of executive participation in that process treads a thin line with respect to judicial autonomy. The Hickenlooper Amendment has been the only legislative attempt to prescribe a zone of jurisdiction for courts confronted with act of state claims. Given the weakness of congressional ac-

---


Notwithstanding any other provision of law, no court in the United States shall decline on the ground of the federal act of state doctrine to make a determination on the merits giving effect the principles of international law in a case in which a claim of title or other right is asserted by any party including a foreign state (or party claiming through such state) based upon (or traced through) a confiscation or other taking after January 1, 1959, by an act of that state in violation of the principles of international law, including the principles of compensation and other standards set out in this subsection: Provided that this subparagraph shall not be applicable (1) in any case in which an act of a foreign state is not contrary to international law . . . or (2) in any case with respect to which the President determines that application of the act of state doctrine is required in that particular case by the foreign policy interests of the United States and a suggestion to this effect is filed on his behalf in that case with the court.

40 For an excellent discussion of the law's shortcomings, see Henkin, Act of State Today: Recollections in Tranquility, 6 Colum. J. Transnat'l L. 175, 178-83 (1967) [hereinafter Act of State Today].

41 Prior to the passage of the Foreign Sovereign Immunities Act of 1976, the law of sovereign immunity was similar to the law before Hickenlooper. Congress, however, acted
tion as well as the perceived need to provide litigants with effective recourse, the Supreme Court developed two additional exceptions to act of state.

2. The Counterclaim Exception

The possibility of a counterclaim exception for act of state cases appeared in dictum in Sabbatino, in which Justice Harlan noted that any counterclaim defended on the basis of act of state would be invalid.

Since the act of state doctrine proscribes a challenge to the validity of the Cuban expropriation decree in this case, any counterclaim based on asserted invalidity must fail. Whether a theory of conversion or breach of contract is the proper cause of action under New York law, the presumed validity of the expropriation is unaffected. Subsequently, the Court held in First National City Bank v. Banco Nacional de Cuba that a foreign sovereign which availed itself of the jurisdiction of U.S. courts to pursue a claim waived the right to assert act of state as a defense.

Banco Nacional sued First National City to recover deposits placed there as collateral for a sovereign loan. When the new government under Fidel Castro nationalized the banks, City Bank offset the deposits to repay the loan. The bank tried to keep $1.8 million of deposited monies in excess of the amount needed to satisfy the obligation. The district court ruled in favor of City Bank on the grounds that the Hickenlooper Amendment applied and that the taking violated customary international law. The Court of Appeals for the Second Circuit reversed the lower court, because the taking of City Bank's branch offices in Cuba occurred within the sovereign's own territory. The court of appeals interpreted the Hickenlooper Amendment to apply only to expropriated property that had been brought back into the United States. It also held that City Bank had no special claim to any funds in excess of the amount due on the

much more affirmatively in the area of sovereign immunity, clearly prescribing when a court has jurisdiction. See infra text accompanying notes 63-76. It has been suggested that similar, improved legislation in the act of state area could eliminate many of the problems that beset the doctrine. See, e.g., DeBusschere, The Act of State Doctrine: Judicial Abstention or Obfuscation? 1985 Der. C.L. Rev. 1045, 1084. See also De Sanchez v. Banco Central de Nicaragua, 770 F.2d 1385 (5th Cir. 1985).

42 Although a counterclaim exception was first espoused by Justice Douglas in First National City Bank v. Republic of China, 348 U.S. 356 (1955), that case involved application of the exception in a sovereign immunity case. See infra notes 51-52 and accompanying text.

43 Sabbatino, 376 U.S. at 439.
46 431 F.2d at 401-02.
defaulted loans.\textsuperscript{47} The Supreme Court expressed no view on the merits of the case but reversed the Second Circuit and remanded for reconsideration in light of a Bernstein letter that had been issued after the Second Circuit opinion.\textsuperscript{48} On remand, the Second Circuit maintained its previous position that Bernstein should be narrowly construed and that act of state prohibited judicial inquiry.\textsuperscript{49} When the case again appeared before the Supreme Court, it held that abstention on act of state grounds would not advance U.S. foreign policy interests and thus was not required.\textsuperscript{50} In a five to four decision, the Court held that act of state did not prohibit City Bank's counterclaim.

Unfortunately, the decision lacked a majority opinion which, in turn, made the case particularly confusing. Justice Rehnquist, who wrote for a plurality of three, noted that the act of state concept was a flexible one which permitted judicial inquiry because of the existence of the Bernstein letter. Justice Douglas concurred in the result reached by the Rehnquist plurality, but thought that the decision was required by an earlier sovereign immunity case that permitted a sovereign's claim to be reduced by offset or counterclaim.\textsuperscript{51} Justice Powell, the fifth vote, concurred on the basis that Sabbatino was too broad. Powell believed that in the absence of evidence that a court's exercise of jurisdiction in an act of state case would actually interfere with foreign relations, the court was obligated to decide the case on its merits by utilizing principles of international law.\textsuperscript{52} Justices Brennan, Stewart, Marshall, and Blackmun dissented on the grounds that "a foreign act of state in certain circumstances was a 'political question' not cognizable in our courts."\textsuperscript{53}

\textsuperscript{47} Id.
\textsuperscript{48} 400 U.S. at 1019.
\textsuperscript{49} 442 F.2d 530 (1972).
\textsuperscript{50} 406 U.S. at 768.
\textsuperscript{51} Id. at 772-73. Douglas based his opinion on National City Bank v. Republic of China, 348 U.S. 356 (1955), which held that sovereign claims could be reduced by counterclaim or by setoff where fair dealing required. Although the case involved a counterclaim exception to the sovereign immunity doctrine, Douglas' application arguably created a legitimate exemption for act of state as well.
\textsuperscript{52} 406 U.S. at 775.
\textsuperscript{53} Id. at 787-88. Justice Brennan continued his dissent by noting the inapplicability of the Bernstein Letter Exception:

Only one—and not necessarily the most important—of those circumstances concerned the possible impairment of the Executive's conduct of foreign affairs. Even if this factor were absent in this case because of the Legal Advisor's statement of position, it would hardly follow that the act of state doctrine should not foreclose judicial review of the expropriation of petitioner's properties. To the contrary, the absence of consensus on the applicable international rules, the unavailability of standards from a treaty or other agreement, the existence and recognition of the Cuban Government, the sensitivity of the issues to national concerns, and the power of the Executive alone to effect a fair remedy for all United States citizens who have been harmed all point toward the existence of a "political question."... [When coupled with the possible consequences to the conduct of our foreign rela-
Six justices rejected the Hickenlooper Amendment's so-called executive suggestion exception. They did not address the Second Circuit's limiting interpretation of the amendment and thus further reduced the effect of the statute. With only three justices expressly adopting Bernstein as an act of state exception, Justice Douglas' counterclaim analogy arguably became another exception to the scope of act of state. Subsequent cases interpreting the exception have resulted in inconsistent applications of the immunity.

3. The Commercial Activity Exception

In Alfred Dunhill of London, Inc. v. Republic of Cuba, a plurality of the Court developed an exception to the act of state doctrine. In Dunhill, the Court held that a Cuban commercial agency's refusal to repay monies mistakenly paid to it was an exercise of commercial rather than sovereign authority and thus was not covered under the doctrine. The majority opinion found no evidence of a governmental repudiation of its obligations. Justice White reasoned that act of state would not apply even if the Cuban government had acted officially:

Subjecting foreign governments to the rule of law in their commercial dealings presents a much smaller risk of affronting their sovereignty than would an attempt to pass on the legality of their governmental acts. In their commercial capacities, foreign governments do not exercise powers peculiar to sovereigns. Instead, they exercise only those powers that can also be exercised by private persons . . . these considerations compel application of the act of state doctrine, notwithstanding the Legal Adviser's suggestion to the contrary. The Executive Branch, however extensive its powers, cannot by simple stipulation change a political question into a cognizable claim.

Id. at 788-89 (footnote omitted).

The amendment's "executive suggestion" very much resembled the Bernstein Letter exception and further reduced the effect of the Bernstein decision. The court of appeals majority found the amendment applicable only to expropriation cases where the property, in some fashion, found its way into the United States at the time of the suit. 431 F.2d 394, 401 (2d Cir. 1970).

Cf. Empressa Cubana Exportadora de Azucary Sus DeRivados v. Lamborn & Co., 652 F.2d 251 (2d Cir. 1981); Banco Nacional de Cuba v. Chase Manhattan Bank, 658 F.2d 875 (2d Cir. 1981); First Nat'l Bank of Boston (Int'l) v. Banco Nacional de Cuba, 658 F.2d 895 (2d Cir. 1981); Banco Nacional de Cuba v. Irving Trust Co., 658 F.2d 903 (2d Cir. 1981); Banco Para El Comercio Exterior de Cuba v. First Nat'l City Bank, 658 F.2d 913 (2d Cir. 1981). At the lower court level, act of state jurisprudence has been made, for the most part, by the Second Circuit. The six 1981 cases noted above all involved Cuban nationalization decrees and the counterclaim exception. Despite similar facts, the case holdings were erratic.

For more on the counterclaim exception, see Note, Rehabilitation and Exoneration of the Act of State Doctrine, 12 N.Y.U. J. Int'l. L. & Pol. 599, 620 & n.137 (1980); DeBusschere, supra note 41, at 1083 ("[I]t cannot be said that there is a valid counterclaim exception to the Act of State Doctrine.").
sons. Subjecting them in connection with such acts to the same rule of law that apply to private citizens is unlikely to touch very sharply on "national nerves" . . . . The mere assertion of sovereignty as a defense to a claim arising out of purely commercial acts by a foreign sovereign is no more effective if given the label of "Act of State" than if it is given the label of "sovereign immunity." 61

The opinion thus created a new commercial activity exception by confusing the commercial activity exemption for sovereign immunity and applying that exception to act of state.

(i) Sovereign Immunity Distinguished from Act of State

The doctrine of sovereign immunity is premised on the belief that a nation-state cannot be sued without its consent because it is engaged in a governmental function. Sovereign immunity prevents a court from exercising jurisdiction over a foreign state. The doctrine originated from the maxim "the King can do no wrong." There was no legal right against an authority that had the sovereign power to make its own laws. 62 Two additional explanations of sovereign immunity are respect for equals and, perhaps more important, the inability of one nation to enforce judgments against another.

The act of state doctrine is similar to sovereign immunity in that both theories operate to protect a sovereign's actions within its own borders from foreign interference. Act of state differs, however, in that the judiciary must decide whether a sovereign's acts can be investigated in a court proceeding which applies domestic or international law. It presumes jurisdiction and then inquires whether the case is justiciable under U.S. law. Sovereign immunity, on the other hand, is jurisdictional. It precludes institution of a suit against a sovereign without the sovereign's consent when the state has acted pursuant to one of its governmental functions. Because a court must inquire about the legality of the state's particular act before deciding whether to apply that state's law, act of state has been called a principle of conflict of laws. 63 In contrast, because it seeks to provide predictable rules concerning goods in international trade, act of state has extraterritorial effects and has been called a rule of international law. 64 The doctrine thus requires judicial forbearance even when a

61 Id. at 703-05.
63 The Restatement of Conflict of Laws provides that a court should examine each of the following factors in determining which state's laws govern: the needs of the international system; the policies and interests of the states involved; the justified expectations of parties; the basic premises underlying an area of law; and, the prospect for uniform results. Restatement (Second) of Conflict of Laws § 6 (1971).
foreign sovereign's act might be repugnant to U.S. law and policy, thereby effectively enforcing the foreign sovereign's act by default. Because both act of state and sovereign immunity have in common a respect for nation-state independence, the two doctrines are often confused.

Sovereign immunity was first explained by the Supreme Court in *The Schooner Exchange v. McFadden*. Chief Justice Marshall's opinion distinguished public from private commercial sovereign acts, but failed to provide guidelines for the distinction. Subsequent courts seized the "absolute independence" language of the opinion and created a category of complete protection for sovereign states, ignoring the possibility of a commercial act exception. This idea of absolute immunity stood for nearly 140 years.

After World War II, the United States began to restrict immunity by negotiating treaties which obligated nations to waive sovereign immunity for state-controlled enterprises that were engaged in commercial business activities. In 1952 the State Department issued a legal advisory letter that expressed the modern view of restricted foreign sovereign immunity. Unrestricted immunity was thought to be inconsistent with the U.S. policy of subjecting itself to tort and contract liability concerning merchant vessels. Consequently, the State Department believed that no immunity should be awarded to actions arising from purely private commercial acts of a sovereign. Though the State Department letter reincarnated *The Schooner Exchange* public-private distinction, it failed to establish guidelines for differentiating public commercial acts from private ones.

The confusion surrounding the two doctrines may lead some to conclude that only one principle is needed. This argument is especially strong where, as with the Foreign Sovereign Immunities Act, Congress has acted with respect to one principle and not the other. For a good discussion of the interaction between the Foreign Sovereign Immunities Act and the act of state doctrine, see Angulo & Wing, *Proposed Amendments to the Foreign Sovereign Immunities Act of 1976 & the Act of State Doctrine*, 14 DEN. J. INT'L. L. & POL'T. 299 (1986).

Almost universal rule is that the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act was done.

65 See *Act of State Today*, supra note 40, at 178.


67 *Id.* at 137.


69 *26 DET'Y ST. BULL. 984 (1952).*

70 Two tests for classification have developed to determine the character of state
Historically, the commercial activity exception for sovereign immunity has not been applied to cases involving an act of state. By engaging in commercial activities, a foreign state implicitly waives its sovereign ability to object to another state's exercise of jurisdiction in matters pertaining to those mercantile actions. Development of a commercial exception out of the sovereign immunity rubric was thus both logical and proper. The same cannot be said about a commercial activity exception to act of state. While the Court in *Dunhill* held that purely private commercial activity did not require deference under act of state, the Court did not decide whether the doctrine was subsumed by sovereign immunity. Whenever a state acts in its own interest, that nation's sovereignty is being asserted. Thus, the act of state defense would remain available irrespective of any commercial component. Because expropriation involves questions of both sovereign authority and commercial law, the validity of *Dunhill*'s commercial exception to act of state remains open to debate.

One focuses on the purpose of the governmental activity. Was the act undertaken to further sovereign objectives? The other test considers the nature of a particular act. Because most commercial transactions with a government could be argued to further sovereign interests, the purpose test is far broader in classifying activities immune. See *Victory Transp. Inc. v. Comisaría General de Abastecimientos y Transportes*, 336 F.2d 354, 360 (2d Cir. 1964), *cert. denied*, 381 U.S. 934 (1965) (labeling the purpose test unsatisfactory).

The objective nature test goes too far, however, in denying a sovereign immunity where that state does in fact engage in a commercial activity such as borrowing from a private bank. The nature test completely ignores the state's national interest or purposes for the borrowing. Neither test, therefore, provides a meaningful guide to defining an activity public or private, the very first step in applying the commercial activity exception. See Note, *Foreign Sovereign Immunity and Commercial Activity: A Conflicts Approach*, 83 COLUM. L. REV. 1440, 1480-82 (1983) (highlighting the conceptual difficulties in both tests).

In 1976 Congress codified a restrictive theory of immunity in section 1603(d) of the Foreign Sovereign Immunities Act which provides, "The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose." 28 U.S.C. §§ 1330, 1332(a)(2)-(4), 1391(d), 1441(d), 1602-1611 (1976). Immunity thus continues to be determined haphazardly by how broadly or narrowly a court defines an activity.

There appear to be a number of misconceptions if the commercial activity exception to the act of state is applied to sovereign risk lending. Though the act of borrowing serves a public function for the sovereign, Justice White's decision would view that action as a private matter simply because parties other than sovereigns engage in that activity. In fact, there are relatively few activities in which a private person could not also engage (witness for example private American contributions to the Nicaraguan Contra movement). Finally, this portion of the opinion ignores the fact that private citizens have federal and state rights to modify lending contracts through bankruptcy. Instead of applying the same principles of law to sovereigns, the *Dunhill* decision, when put in the context of international lending, actually would place the sovereign in a much more disadvantaged position than a private citizen.
4. The Treaty Exception

The Sabbatino decision created yet another avenue for judicial abstention on act of state grounds. When the court refused to determine the validity of Cuba's seizure and nationalization, it did so on the ground that international law did not provide a clear basis for adjudicating the validity of the expropriation.\(^{75}\)

The greater degree of codification or consensus concerning a particular area of international law, the more appropriate it is for the judiciary to render decisions regarding it, since the courts can then focus on the application of an agreed principle to circumstances of fact rather than on the sensitive task of establishing a principle not inconsistent with the national interest or with international justice . . . . Therefore, rather than laying down or reaffirming an inflexible and all-encompassing rule in this case, we decide only that the Judicial Branch will not examine the validity of a taking of property within its own territory by a foreign sovereign government extant and recognized by this country at the time of suit, in the absence of a treaty or other unambiguous agreement regarding controlling legal principles, even if the complaint alleges that the taking violates customary international law.\(^{76}\)

The inference drawn from the opinion is that if nations, through treaty or other agreement, could decide applicable principles governing their behavior, domestic courts could try disputes without fear of the act of state doctrine's prohibition.

Having apparently paved the way for international law to empower domestic courts to consider the appropriateness of a taking, the Sabbatino Court identified expropriation as an issue subject to such divided opinions that the treaty exception could not be applied.\(^{77}\) Twenty-four years later, the same divergence of opinion concerning sovereign debt expropriation and international law still exists. By and large, the contentions center on whether an expropriating state must pay compensation to the injured party.\(^{78}\) International law is based in large part on customs recognized by a majority of nations. With debt expropriation, there is disagreement over the recognition that should be afforded customary law. Many developing nations are coming to view debt restructuring, and perhaps repudiation, as an adjunct to their development. Repayment of massive


\(^{76}\) Id. at 428.

\(^{77}\) Id.

debt is seen as a device to keep developing countries economically immature. Further, the issue of how to factor international law into U.S. jurisprudence is a question still open to debate.  

Even assuming judicial competence, the remedial issue of ordering compensation is also problematic. Unless an expropriating state has substantial assets within U.S. boundaries, a court order of compensation may be worth little if anything. In addition, even nations that have signed treaties concerning applicable legal principles have balked where application of the agreement has been deemed to have a potentially harmful effect. Thus, the effect of the treaty exception must also be called into question.  

Courts faced with act of state cases encounter conceptual difficulties not only with the doctrine itself, but also with each of the five exceptions: 1) the Bernstein Letter exception; 2) the Hickenlooper Amendment; 3) the counterclaim exception; 4) the commercial activity exception; and 5) the treaty exception. Although Sabbatino stated the doctrine's theoretical origins, the decision did not outline which factors lower courts should consider when making the threshold decision to abstain from applying U.S. law. The exceptions reflect the difficulties that the Supreme Court has had with property seizures by foreign nations. When the highest court is uneasy with a doctrine and fails to clarify its basis, it is not surprising that lower courts are confused completely. How should courts balance the desire to provide a forum for parties allegedly injured by a sovereign's acts with the principles of international comity and executive conduct of foreign policy? Many commentators have called for a reformulation of

---

79 See, e.g., Gerber, Beyond Balancing: International Law Restraints on the Reach of International Laws, 10 YALE J. INT'L L. 185-221 (1984). One could argue that acts of state are questions of domestic, procedural law and not international law issues. If this contention were accepted, the next analytical step would be much easier: once within the realm of domestic law, the question of whether the defense of expropriation is legitimate, becomes one of federal common law and is subject to review and change by any of the three branches of government. Cf. Bower, Claims Between States and Private Entities: The Twilight Zone of International Law, 35 CATH. U. L. REV. 929 (1986); Butcher, The Consensus of United States Positions on International Law with Advisory Opinions of the International Court of Justice, 30 HOW. L. J. 45-91 (1987); Henkin, International Law as law in the United States, 82 MICH. L. REV. 1555 (1984); Leich, Contemporary Practice of the United States Relating to International Law, 81 AM. J. INT'L L. 405 (1987).  

80 Admittedly, an adverse judgment against a foreign sovereign in an American court may provide a basis for forcing the U.S. government to help individual plaintiffs in seeking recovery. However, it is suggested that judicial declarations of liability would do more to inflame a sovereign than executive intervention before judgment.  


the standards used in deciding when to apply the doctrine.\textsuperscript{83}

\section*{II. International Sovereign Debt: Problems for Act of State}

The historical roots of act of state lie in transactions involving expropriated tangible property. Originally developed from accounts receivable deals, the doctrine could be applied effectively, depending upon the location of the subject goods. If products were outside the United States, a domestic court could not attempt to adjudicate the validity of a foreign sovereign's seizure of the property. Property situs has been a court's first step in determining whether a claim is prohibited by the act of state doctrine.

A situs test, however, is inappropriate in cases involving sovereign debt. Debt is an intangible which gives a creditor the right to enforce another's obligation by judicial action.\textsuperscript{84} In \textit{Alfred Dunhill},\textsuperscript{85} the Court noted correctly that Cuba's act of state defense would not apply because the tangible property in question, cigars, was located in New York and thus outside the foreign sovereign's territory. Property located outside a sovereign's borders did not give a country the same expectation of dominion through expropriation as property within the foreign state's geographic territory.\textsuperscript{86} When a case involves the right to repayment of a loan, however, the Court's determination of debt situs is an act of whim rather than reason. Act of state is premised on notions of inter-jurisdictional deference and reciprocity as these relate to a nation's competence to prescribe rules of law. Debt situs is a function of these inter-jurisdictional factors and can be determined only by examining both foreign State and forum State (U.S.) interests.

\subsection*{A. The Concept of Debt Situs}

There have been two generally stated methods of determining debt situs in act of state cases. The first test was articulated in \textit{Harris v. Balk},\textsuperscript{87} in which the Court held that debt clings to the debtor. Thus a court could assert jurisdiction over a debt only if it could claim personal jurisdiction over the debtor. The \textit{Harris} Court recognized that intangibles, unlike real or tangible personal property, have no physical attributes that would assist a court in determining loca-
tion. The Court expressly refused to attempt to determine debt situs:

'The situs is unimportant. It is not a question of possession in the foreign state, for possession cannot be taken of a debt or of the obligation to pay it, as tangible property might be taken possession of.'

Though much of the *Harris* decision was overruled in *Shaffer v. Heitner*, the portion of its analysis on debt situs remains good law.

In *Menendez v. Saks & Co.*, the Court of Appeals for the Second Circuit applied the *Harris* debt situs test and found that a foreign sovereign had no power to enforce or collect a debt unless it was located within that sovereign's territory. Because U.S. courts had jurisdiction over the debtor, the court located the debt in the United States and refused to apply the act of state doctrine. On appeal, the Supreme Court reversed the lower court's decision except that portion on debt situs. The Court assumed that jurisdiction over a debt was an either-or proposition between the United States and a foreign sovereign. It did not consider the possibility of both countries asserting jurisdiction.

Can a debt be located in more than one place? With intangible property such as debt, a foreign state can claim jurisdiction because the debtor, whether the sovereign itself or a sovereign-approved entity, is present in the country. U.S. courts can also claim jurisdiction over a dispute on contract principles, because most sovereign debtors typically consent to U.S. jurisdiction in the loan documentation. Thus, a case for two countries claiming domain can be made without obstacle. Claimed jurisdiction over a debtor, therefore, does

88 *Id.* at 223.

89 *Id.* at 212 n.39 (held: the Harris attachment of a debt to obtain jurisdiction did not meet the minimum contacts standard of *International Shoe v. Washington*, 326 U.S. 310 (1945)).


92 485 F.2d at 1364.

93 *Id.* at 1365-66.


95 There are numerous early domestic cases that fix debt situs in the state of the creditor's domicile. *See*, e.g., *Texas v. New Jersey*, 379 U.S. 674 (1965), *McCulloch v. Franchise Tax Board*, 61 Cal. 2d 186, 390 P.2d 412, 37 Cal. Rptr. 636 (1964), *reh'd denied*, 379 U.S. 984 (1965); *Fenton v. Edwards & Johnson*, 126 Cal. 43, 46, 58 P. 320 (1899). Most of these cases placed the situs with the creditor to enable the creditor's state of domicile to tax property or income derived from the property. *See also* *Waite v. Waite*, 99 Cal. Rptr. 325, 329, 492 P.2d 133, 137, 6 Cal. 3d 461 (1972). The *Waite* Court also noted that when an issue involved jurisdiction to compel an obligor to pay a claimant, personal jurisdiction over the debtor became the key determinant. *Id.*

One might also challenge the actual "consent to jurisdiction" involved in many sovereign loan contracts. Inasmuch as many debtor nations have no true alternative to private borrowing, the claim that such a provision was entered into willingly and knowingly is subject to question.
not resolve the initial question of debt situs, or the more important issue of whether act of state requires judicial abstention.

A second debt situs test, known as the complete fruition requirement, was developed in *Taclera Severiano Jorge v. Standard Cigar Co.*,²⁹⁶ in which the Court of Appeals for the Fifth Circuit required that a determination be made whether a foreign sovereign had physical control over a debt at the time of expropriation. Absent physical control, a taking did not come to “complete fruition” and the act of state doctrine did not bar a U.S. court from hearing argument.²⁹⁷ *Taclera* involved accounts receivable on a sale of goods. The court of appeals based its decision on the physical control of the goods rather than on any principle or theory concerning intangible property. Under *Taclera*, courts could work legal witchcraft in order to place intangible property at their doorsteps.²⁹⁸

Recently, the U.S. District Court for the Southern District of New York modified the *Harris* test for locating the situs of a sovereign debt. In *Libra Bank Ltd. v. Banco Nacional de Costa Rica*,²⁹⁹ the court examined the debtor state’s reasonable expectations of dominion over property. Because the loan documentation in the case stated that the debt was payable in New York, the court rejected the Costa Rican bank’s act of state defense and found that the incidents of debt were located in New York.³⁰⁰ Judge Motley justified the

---

²⁹⁶ 392 F.2d 706, 714-16 (5th Cir. 1966), cert. denied, 393 U.S. 924 (1968).
²⁹⁷ For an excellent discussion of the two tests and the problems generated by debt situs rules generally, see Note, *The Act of State Doctrine: Resolving Debt Situs Confusion*, 86 COLUM. L. REV. 594 (1986). See also United Bank, Ltd. v. Cosmic Int’l, Inc., 542 F.2d 868 (2d Cir. 1976)(the inability of a foreign state to complete an expropriation within its territorial borders reduces the state’s expectations of dominion over the property; judicial disposition, therefore, is less likely to vex the foreign state).
²⁹⁸ See Lowenfeld, *In Search of the Intangible: A Comment on Shaffer v. Heitner*, 53 N.Y.U.L. REV. 102 (1978)(arguing that intangibles have no situs at all and that debt is located wherever personal jurisdiction can be obtained).
court’s decision to hear the case by implying that the borrower, a bank wholly-owned by the government of Costa Rica, had somehow contractually waived its sovereign rights. "It can hardly be said that this court’s judgment shall frustrate the foreign state’s reasonable expectations of dominion over the legal rights involved therein so as to vex our amicable relations with that foreign nation.” 101 The very converse of this was true, however.

An incidents of debt analysis ignores the very fact that a sovereign borrower’s circumstances may have changed and led the debtor country to take drastic economic action to carry out a principle. Judicial review in the face of extraordinary measures, such as the Costa Rican Central Bank’s intervention in Libra Bank, denies recognition of the sovereign. The decision not only endangers relations between Costa Rica and the United States, but also acts as a signal to other nations that U.S. creditor interests take precedence over a debtor country’s legitimate efforts to handle threats to its economy. Such actions clearly present the potential for vexing foreign relations.

B. Debt Situs Confusion: Allied Bank

The flawed logic of applying act of state’s situs requirement to a pure lending transaction again was exposed in Allied Bank International v. Banco Creditor Agricola de Cartago, 102 which involved facts identical to those in Libra Bank. Allied was agent for a lending syndicate of thirty-nine banks which made loans to three banks wholly-owned by the Republic of Costa Rica. 103 The three borrowing banks executed a series of promissory notes payable to syndicate members. The notes were denominated in U.S. dollars and payable in New York. Additionally, each note contained a provision subjecting the Costa Rican banks to New York jurisdiction.

The Costa Rican banks made timely payments on the notes until July 1981. At that time the Costa Rican Central Bank, which had direct control of the three borrowing banks, issued regulations that suspended all external debt payments. By November 1981, the Costa Rican government blocked all payment of foreign debts in U.S. dollars. The lenders declared a default and sued the borrowers in the U.S. District Court for the Southern District of New York. The district court found in favor of the Costa Rican banks on act of state grounds without discussion or application of debt situs rules. 104

101 570 F.Supp. at 884 (emphasis added).
103 566 F.Supp. at 1442. For a discussion of syndicated lending, see Knight, Loan Participation Agreements: Catching Up With Contract Law, 1987 COLUM. BUS. L. REV. 587.
104 566 F.Supp. at 1444. The court also held that the execution of promissory notes constituted a commercial activity within the meaning of the Foreign Sovereign Immunities Act and thus the action was excepted from the defense of sovereign immunity. Id. In
Judge Griesa rested the opinion on Sabbatino's separation of powers rationale:

A judgment in favor of Allied in this case would constitute a judicial determination that defendants must make payments contrary to the directives of their governments. This puts the judicial branch of the United States at odds with policies laid down by a foreign government on an issue deemed by that government to be of central importance. Such an act by this court risks embarrassment to the relations between the executive branch of the United States and the government of Costa Rica.105

During the summer of 1983, while the appeal was still pending, all but one of the thirty-nine syndicate members agreed to reschedule the debt. Both the Costa Rican government and the country's central bank signed the refinancing agreement. The thirty-ninth syndicate member, Fidelity Union Trust of New Jersey, refused to reschedule and demanded that Allied, as syndicate manager, bring appeal in the Court of Appeals for the Second Circuit.

The Court of Appeals (Allied I) affirmed the lower court’s decision, rejecting the plaintiff’s argument that the act of state doctrine did not apply because the debt was located outside Costa Rica.106 The court compared Costa Rica's suspension of external debt obligations to reorganization under Chapter 11 of the Bankruptcy Code.107 Thus, the country's actions were found to be consistent with U.S. law and policy. The decision returned act of state analysis to the days of Underhill and considerations of international comity. Banks would no longer be able to structure their loan agreements to assure enforcement in the United States. The Allied I decision thus called the very enforceability of sovereign debt into question.

With Justice Department support for its position, Allied Bank petitioned for and was granted a rehearing. In a throwback to Bernstein, the department's amicus curiae brief argued that the Second Circuit's decision was based on a misunderstanding of U.S. policy. Unlike Bernstein, however, neither the Justice Department nor the State Department had articulated a position on the role of private sovereign debt restructuring previously. The government's brief described the Allied opinion as a cloud over rescheduling discussions:

[A]n important element in the functioning of this process has been the willingness of commercial banks to reschedule debt and to provide credit to countries undertaking adjustment efforts. The confidence of lenders in the enforceability of their loan agreements payable in New York is critical to their willingness to extend international credit. However, this Court's opinion introduces significant

refusing to exempt Costa Rica's actions under act of state, the court essentially disapproved of Dunhill's commercial activity exception.

105 Id.
106 733 F.2d 23 (2d Cir. 1984), vacated, 757 F.2d 516 (2d Cir.), cert. denied, 106 S.Ct. 30 (1985).
107 Id. (citing 11 U.S.C. §§ 1101-1174 (1982)).
uncertainties into the process of making and interpreting international financial agreements, leaving unclear, to debtors and creditors alike, the circumstances under which United States courts will give effect to a foreign government's action limiting payments of obligations in the United States. Consequently, the United States Government believes that the Court's opinion may well discourage commercial lenders from providing essential new financing and could adversely affect the taking of adjustment measures. If these developments were to occur, the orderly resolution of debt problems could be seriously jeopardized.\(^{108}\)

At rehearing, the court reversed its earlier decision and awarded summary judgment for Allied (\textit{Allied II}).\(^{109}\) The court paid particular attention to the portion of the government brief which took issue with the prior court's interpretation of U.S. foreign policy regarding Costa Rica. Rescheduling, the government argued, was a cooperative venture between contracting parties. Costa Rica's repayment regulations amounted to a unilateral attempt to alter its commercial debt and was thus inconsistent with international cooperation advocated by both the International Monetary Fund and U.S. policy.\(^{110}\)

The court was convinced by these arguments, stating that "[i]n light of the government's elucidation of its position, we believe that our earlier interpretation of United States policy was wrong."\(^{111}\) The court then applied the \textit{Harris} debt situs test, finding "Costa Rica's potential jurisdiction over the debt . . . not sufficient to locate the debt there for the purpose of act of state doctrine analysis."\(^{112}\) In reaching its conclusion, the court noted three specific U.S. interests: 1) the orderly resolution of international debt problems; 2) the interests of the United States continuing as a major source of private international credit; and 3) principles of contract law.\(^{113}\) "Acts of foreign governments purporting to have extraterritorial effect—and consequently, by definition, falling outside the scope of the act of state doctrine—should be recognized by the courts only if they are consistent with the law and policy of the U.S."\(^{114}\)

The court in \textit{Allied I} properly considered \textit{Sabbatino}’s balancing requirement. The court’s bankruptcy analogy not only acknowledged the sovereign’s efforts to address its monetary crisis, but it also al-

\(^{108}\) Brief for the U.S. as Amicus Curiae 6-7, Allied Bank Int'l v. Banco Credito Agricola de Cartago, 733 F.2d 23 (2d Cir. 1984) [hereinafter Government Brief]. The brief was supported jointly by the Department of Justice, State, and Treasury, and by the Federal Reserve Board.

\(^{109}\) 757 F.2d at 518.

\(^{110}\) "While the parties may agree to renegotiate conditions of payment, the underlying obligations to pay nevertheless remain valid and enforceable." Government Brief, supra note 108, at 7.

\(^{111}\) 757 F.2d at 520.

\(^{112}\) Id. at 522.

\(^{113}\) Id.

\(^{114}\) Id.
lowed the court to balance those interests against the concerns of the Allied lending syndicate.

The court’s findings in *Allied II* were chauvinistic in the sense that only U.S. creditor interests were addressed. There was neither explanation nor justification for the court’s applying territorial limitations to the Costa Rican debt. In effect, the holding required sovereign debtors to violate their own domestic laws in favor of a U.S. lender. Costa Rica promulgated its regulations out of need, not animosity. Suspension of debt payments was a last-ditch effort to restructure a crippling economic situation. Under *Allied II*’s interpretation, any effort not approved by either U.S. banking interests or the federal government would be against U.S. policy and thus act of state would not apply.

The *Allied II* court failed to consider the policies behind Costa Rica’s repayment regulations and the reasons why those actions were taken unilaterally. The decision was extraordinary because the executive branch deemed it appropriate not to participate in debt restructuring talks between private banks and the government of Costa Rica.\(^{115}\) Despite the court’s suggestion to the contrary, Costa Rica’s actions were sovereign acts. Once the regulations were announced, the transaction ceased to be a purely private affair. A sovereign entity had acted in its own best interests. The fact that the sovereign’s actions posed a substantial risk to U.S. corporate citizens should be a proper concern of the court. The risk also should be a proper concern of the branch of government charged with conducting foreign policy, the executive. Costa Rica’s actions made the matter an issue

\(^{115}\) To its credit, the government did recognize Costa Rica’s attempt to restructure its debt and even approved foreign aid despite the fact that Costa Rica’s failure to pay its foreign debt triggered the provisions of section 620(q) of the Foreign Assistance Act, 22 U.S.C. § 2370(q) (1976), which prohibits U.S. aid to any country in default on loan payments to the United States unless the President advises the Congress that “assistance to such country is in the national interest . . . .” Pursuant to the statutory requirement, the President, through the Secretary of State, certified to Congress:

In accordance with . . . the Foreign Assistance Act of 1961 . . . . I have determined that it is in the national interest to furnish assistance under the Act in Fiscal Year 1983 to Costa Rica, notwithstanding that the Government of Costa Rica is more than six months in default in payment to the United States of principal and interest on loans made under the Act.

Continuation of U.S. assistance to Costa Rica is consistent with the commitment of this administration and in Congress to help Costa Rica regain economic viability . . . .


of foreign policy whether the U.S. government wanted it to be or not.

The Justice Department brief in Allied II did not outline any executive plan of active involvement in the rescheduling talks. Instead, the brief suggested that the administration’s position on private sovereign debt was not inconsistent with the desires of the United States either to aid in restructuring Costa Rica’s intergovernmental obligations or to provide foreign aid to the Central American nation. The court meekly accepted these statements without examination. Forty years after Bernstein, the executive branch could still lead the judiciary down a path without any explanation of its decision.

Acts of state involving intangible property require judicial rethinking because the desired effect—to limit the role of courts in foreign policy—is not accomplished. Rather, the real effect of the doctrine is to shield the executive branch’s foreign policy positions from scrutiny of any kind. Unlike instances involving tangible property located outside the sovereign’s territory, Costa Rica had, and continues to have, expectations of dominion over its external debt. A government’s inability to manage its economic affairs not only threatens that nation’s creditors, but also risks the stability of the debtor nation. By giving little consideration to Costa Rica’s reasons for its repayment moratorium, the Allied II court ignored the policy considerations underlying the doctrine and created a foreign policy of nonrecognition of the sovereign acts of another country. In this instance, the threat to amicable relations between a debtor nation and the United States is real and substantial.

The economic relationship between the United States and other countries is also at risk from the precedent established in Allied II. If a U.S. court refuses to recognize one nation’s sovereign acts, why should another country expect different treatment where its laws and regulations are involved? Would there be any reason for another nation to give credence to U.S. sovereign acts that have extraterritorial effects? The Allied II decision permits the administration to disrupt the best mechanism for resolving international debt problems and for maintaining amicable foreign relations: cooperative discussions which involve the debtor nation, creditor banks, and the U.S. government.

III. Toward Judicial Participation: Reconsidering Act of State

The decision to hear a case involving sovereign debt is a political judgment and one that the judiciary is ill-equipped to make. The executive branch, with its wealth of diplomatic and intelligence information, is far more capable of predicting how another nation might respond to the judiciary’s investigation of the country’s sovereign decisions concerning its debt obligations. In addition, the executive
branch is also best-suited to avoid international misunderstandings that could be caused by a court’s ruling adverse to a foreign sovereign’s interests. Yet despite its power, the executive often does not become involved in alleged wrongful expropriation cases. When the administration does enter the process, it usually does so only on the fringe—by issuing curt statements that U.S. foreign policy interests will or will not be affected.\(^{116}\) In the absence of a Bernstein Letter or some other executive acknowledgement as in Allied II, a court can do no more than speculate about the ramifications of making a decision. Even where the court adheres to the executive’s recommendations in a particular matter, a decision to try a case using domestic law likely would have consequences for U.S. foreign policy. Undoing the harm to foreign affairs from a decision adverse to a foreign sovereign might be impossible.

Current act of state analysis presents the judiciary with three bad choices: 1) apply U.S. law and risk insulting the sovereign by an adverse ruling and possibly damaging U.S. foreign relations; 2) apply foreign law and deny an aggrieved lender of its expected and agreed-upon forum,\(^{117}\) or 3) refuse to apply either U.S. law or foreign law and effectively abstain from hearing the dispute.\(^{118}\) None of these choices gives effect to the vital concept of respect for comity among nations, while all involve the cost of denying an aggrieved lender a remedy.

A. Abstention as a Statement of Foreign Policy\(^{119}\)

In the United States, recognition of the act of state doctrine arose from a concern with international relations and a desire to preclude the judiciary from making foreign policy. It was thought that courts posed less of a risk to foreign affairs if they refused to act. Abstention, however, is not the best way to develop amicable international relations. In refusing to hear argument and evidence of an expropriation, a court in effect makes foreign policy when it accepts without examination the validity of the foreign sovereign’s act. One important question that courts should ask is what effect abstention will have on subsequent cases. Judicial policy-making has long been a species of federal common law. Until \textit{Erie v. Tompkins}\(^{120}\) the Supreme Court routinely made common law without considering the

\(^{116}\) But see supra note 115.

\(^{117}\) See supra note 8. This choice may result in a \textit{fait accompli} in favor of the foreign sovereign. It is doubtful that the foreign sovereign’s law would invalidate a state act like debt postponement or nonpayment.

\(^{118}\) This seems to be the preferred choice of many courts.

\(^{119}\) While the same arguments concerning foreign policy could be made for traditional expropriations cases, the discussion in this section is intended to be limited to sovereign debt cases.

\(^{120}\) 304 U.S. 64 (1938).
possibility that such decisions might interfere with either state sovereignty or with the idea of coequal branches of government.\footnote{Although some post-\'Ette cases suggest that this type of judicial law making, in the absence of other governmental advice, violates the spirit of the separation of powers principle, it is virtually unquestioned that courts can and do make law by both acting and refusing to act.}{121}

An important function of courts is to provide a forum for parties claiming injury. In \textit{Sabbatino}, the Court weighed this purpose against the likelihood that judicial inquiry might offend a foreign government and thus affect foreign relations with that country. Courts faced with alleged acts of state had to conduct a three-part inquiry to determine the scope of review: 1) whether review would offend a foreign sovereign; 2) whether the executive's foreign policy efforts would be compromised if review was granted; and 3) assuming review, whether it would provide a basis for effective relief. Under the act of state doctrine, an affirmative answer to either of the first two questions or a negative response to the third meant that the court should refuse to hear the case.

A triple inquiry to decide justiciability not only consumes judicial resources unwisely, but also fails to achieve its stated purpose of avoiding judicial consideration of foreign policy issues. Few would question whether any court decision on the merits would likely offend a foreign government. Further, there are no governing statutes or legislative history a court can examine to determine the validity of a foreign government's actions. The \textit{Allied I} court's analogy to federal bankruptcy law has been the only attempt to relate sovereign debt with another related area of law.

Takings without just compensation have long been recognized as violations of international law,\footnote{See D. Weigel & B. Weston, \textit{Valuation Upon The Deprivation of Foreign Enterprise: A Policy-Oriented Approach To The Problem of Compensation Under International Law} 4 (R. Lillich ed. 1972).}{122} yet \textit{Banco Nacional} failed to instruct courts on how to factor international law into the decision-making process.\footnote{Indeed, the Court noted that the doctrine even applied to acts which violated international law "in the absence of a treaty or other unambiguous agreement regarding controlling legal principles . . . ." 376 U.S. at 428.}{123} There continues to be widespread disagreement in interpreting applicable international dispute resolution principles.\footnote{\textit{See supra} notes 75-79 and accompanying text for a discussion of what constitutes customary international law.}{124} It is thus possible that international law is in sufficient disarray such that it cannot produce an effective remedy based upon any acceptable principles. This is particularly the case with sovereign debt. Many developing debtor nations see bank demands for austerity as conditions precedent to additional extensions of credit as unacceptable.\footnote{Brazil, for example, stopped paying interest on about $67 billion of its foreign bank debt on February 20, 1987, as a means of developing some leverage in debt restruc-}{125}
Professor Henkin has suggested that the Court in *Banco Nacional* intended to announce a more limited concept of act of state, namely, that the doctrine does not give parties any:

- rights, remedies or defenses against a foreign government for its violations of international law . . . that while international law is part of the law of the United States, the law of the United States has no application to what Castro did in Cuba . . . . Whether and how the United States wished to react to such violations are domestic, political questions: the courts will not assume any particular reaction, remedy, or consequence.\(^\text{126}\)

The implication that courts should not respond at all to foreign expropriations is troublesome. Given the limits of international dispute resolution, in the absence of judicial inquiry there is no effective basis for relief.\(^\text{127}\) Henkin’s explanation leaves courts with only one choice—to risk violating the separation of powers principle by seeking executive pronouncements that review would not interrupt foreign policy.

The administration frequently refuses to announce its position in private commercial affairs. Executive silence, however, should not be interpreted to mean that a court must refrain from exercising jurisdiction.\(^\text{128}\) A court’s refusal to hear an expropriation case constitutes both implicit acknowledgement of a taking and a foreign policy position that this country will not inquire further. It is therefore specious to suggest that abstention is the best means to avoid the court’s making foreign policy. The Supreme Court recognized this in *Banco Nacional* by allowing the creation of a variety of exceptions.\(^\text{129}\)

### B. American Banking Law: Beyond Executive Discretion

A more helpful view of the act of state doctrine should concentrate on the sovereign acts of the United States. The executive’s unfettered discretion to intervene in matters involving sovereign debt permits it to avoid addressing important issues of national policy by hiding behind the judiciary’s abstention shield. Act of state should be reinterpreted to recognize the role of judicial review in overseeing the executive’s obligation to act as an intermediary in restructing foreign sovereign debts. The underlying principles of the doctrine can be met only by a court providing limited review of sovereign repayment cases under U.S. law and, where appropriate, or-

---

\(^\text{126}\) L. Henkin, *Foreign Affairs and the Constitution* 223-24 (1972) (footnote omitted).

\(^\text{127}\) See supra notes 117-18 and accompanying text.

\(^\text{128}\) See supra notes 22-28 and accompanying text.

\(^\text{129}\) See supra notes 42-83 and accompanying text.
dering the executive to explain its position on participation (or lack of it) in working to resolve the sovereign debtor’s repayment problems. Such an approach would permit the courts to weigh the executive’s position on foreign policy vis-à-vis sovereign debt against a creditor claimant’s interests and expectation of judicial protection of contractually-created rights.

The allocation of foreign affairs powers presents a major stumbling block in revising act of state theory to advocate judicial activism. The Constitution does not provide any branch of government with an express power to conduct foreign relations principally. Congress is given the authority to regulate commerce with foreign nations, to prescribe offenses against the law of nations, and to declare war. The President, with the advice and consent of the Senate, has the capacity to make treaties and appoint ambassadors. Though the Constitution envisions cooperation between these two branches, it is generally acknowledged that the President has the primary role in conducting foreign policy. One of the problems with this interpretation is the degree of discretion vested in the executive. Courts cannot order the President to do anything that the office has not been required to do either by Congress or under the Constitution. The idea of executive discretion in foreign affairs has prevented courts from examining executive pronouncements of policy in cases of international debt restructuring.

It goes without saying that sovereign debt repayment is a matter of foreign affairs. Although affairs between nations principally involve political relations conducted by the political branches (i.e., executive and legislative), it would be remiss to discount or ignore the role of the judiciary. The ordinary business of courts can affect U.S. foreign relations. Judges have the power to involve their courts in foreign affairs in a number of ways: in cases arising under the Constitution, laws or treaties of the United States, by review of federal administrative agency activities that effect other nations, and by review of the actual foreign activities of administrative agencies. In sovereign debt cases, courts must balance review power in a foreign affairs matter with the court’s function as arbiter in the process of resolving specific disputes between parties. Unfortunately, many courts have been less willing to review decisions by the political branches even when a failure to do so would prevent resolution of a

131 U.S. CONST. art. II, § 2, cl. 2.
132 L. Henkin, supra note 126, at 37-38.
133 Professor Henkin also did not rule out the possibility that courts could assume authority to hear an expropriation case. Congress could legislate that the courts should refuse to recognize the sovereign act, or should give a remedy against the sovereign. Id. at 224.
134 See id. at 205.
135 See U.S. CONST. art. III, § 3.
conflict.\textsuperscript{136}

One notable exception to judicial review of political action involves foreign affairs that allegedly violate individual rights. One aggrieved in person or property by an act of a political branch can make a constitutional challenge, most often alleging that the political action deprives one of property or person without due process of law.\textsuperscript{137} It seems plausible that U.S. banks could argue that executive inaction or refusal to participate in debt restructuring talks, led to a taking without due process, especially when given the fact that most sovereign lending contracts provide that U.S. law governs.

For the most part, however, courts have cited foreign affairs as an area akin to political questions\textsuperscript{138} and "elevated judicial abstention to a principle that courts will not decide political questions."\textsuperscript{139} Other than its acceptance and use in the common law, the political question doctrine, like act of state, is far from being a well-justified or well-explained concept. Not only has the constitutional basis for the doctrine been questioned, but the "remedy" of abstention is also uncertain.

In \textit{Baker v. Carr},\textsuperscript{140} Justice Brennan wrote that courts could recognize a political question because it would involve a constitutionally textual commitment to a political department; a lack of judicially discoverable and manageable standards for resolution of the dispute; the impossibility of deciding a case without an initial determination of a kind which went beyond judicial discretion; or, the possibility that a decision would disrespect another branch of government.\textsuperscript{141} The Court also acknowledged, however, that it would be error to suppose that every case or controversy which touches foreign relations lies beyond judicial cognizance. Our cases in this field seem invariably to show a discriminating analysis of the particular question posed, in terms of the history of its management by the

\textsuperscript{136} Scholars still dispute whether courts have constitutional authority to declare acts of Congress unconstitutional, or whether courts have developed such a power on their own. \textit{Cf.} Wechsler, \textit{Toward Neutral Principles of Constitutional Law}, 73 \textit{Harv. L. Rev.} 1 (1959), \textit{with} L. Hand, \textit{The Bill of Rights} (1958). That courts do make law by declaring such acts constitutional or not, is undisputed.


\textsuperscript{138} For an excellent general discussion of the political question doctrine, see Scharpf, \textit{Judicial Review and the Political Question: A Functional Analysis}, 75 \textit{Yale L.J.} 517 (1966).

\textsuperscript{139} L. Henkin, \textit{supra} note 126, at 210. Though the Court in \textit{Sabbatino} never stated exactly what required abstention in act of state cases, it noted that the doctrine was not required by sovereignty, international law, the political question doctrine, or anything in the Constitution but that the doctrine had philosophical underpinnings in each of these areas. Thus, it would not be error to examine any of these underpinnings. See \textit{supra} note 29.

\textsuperscript{140} 369 U.S. 186 (1962).

\textsuperscript{141} \textit{id.} at 217.
political branches, of its susceptibility to judicial handling in the
light of its nature and posture in the specific case, and of the possi-
ble consequences of judicial action.\textsuperscript{142}

Thus, the Supreme Court has recognized that the Constitution does
not make foreign affairs an exclusive province of only the legislative
and executive branches.

Through the use of procedural tools for joining parties\textsuperscript{143} and
the remedy of declaratory action,\textsuperscript{144} courts can aid in developing a
solution to sovereign debt disputes. The concept of joinder revolves
around the broad principle that two or more parties cannot be
grouped together and joined in a suit where no mutuality of interest
exists.\textsuperscript{145} In sovereign debt cases the executive branch has a mutual
interest in the debtor-creditor relationship in two ways. First, there
exists the constitutional concern that any court proceeding might en-
danger U.S. relations with a debtor country.\textsuperscript{146} Second, there also
exists a legislative basis for joining the executive and shattering the
facade of executive discretion.

The entire bank regulatory framework in the United States is
designed to promote safe and sound banking practices.\textsuperscript{147} In the
Banking Act of 1933,\textsuperscript{148} Congress stated that the two primary pur-
poses of bank regulation were to ensure public confidence in the
banking system by maintaining viable institutions and protecting de-
positors through bank examinations and by deposit insurance.\textsuperscript{149}
Congress established the Federal Deposit Insurance Corporation
(FDIC) to execute these charges. All federally-chartered commercial

\textsuperscript{142} Id. at 211-12 (objecting to the broad language used to explain abstention in the act
of state case of Oetjen v. Central Leather Co., 246 U.S. 297 (1918)).


\textsuperscript{146} See supra notes 119-29 and accompanying text.

\textsuperscript{147} Banking Act of 1933, Pub. L. No. 66, 48 Stat. 162 (1933)(codified as amended at
12 U.S.C. §§ 1811-1832 (1982)) (provision stating "to provide for the safer and more ef-
fective use of the assets of banks, to regulate interbank control, to prevent the undue
diversion of funds into speculative operations, and for other purposes") and 12 C.F.R.
§§ 3901-3912 (Supp. 1985).


\textsuperscript{149} Id. at 166, 168 (codified as amended at 12 U.S.C. §§ 338, 1811 (1982))(providing
for the examination by the Federal Reserve Board of state bank affiliates and amending the
Federal Reserve Act by creating the Federal Deposit Insurance Corporation to insure bank
deposits).

[T]he purpose of this legislation is to protect the people of the United States
in the right to have banks in which their deposits will be safe. They have a
right to expect of Congress the establishment and maintenance of a system
of banks in the United States where citizens may place their hard earnings
with reasonable expectation of being able to get them out again upon demand.

SCHLICHTING & J. COOPER, BANKING LAW § 96.02[2] (1987)(detailing the history and
events leading to the enactment of the Banking Act of 1933, also known as the Glass-
Steagall Act).
banks and all state-chartered banks that are members of the Federal
Reserve System are required to acquire deposit insurance and sub-
mit to regulatory examination. Thus, direct executive supervision
of the nation’s 14,000 commercial banks is envisioned.

Despite this required oversight, neither the FDIC nor the two
other federal agencies have promulgated regulations that govern
U.S. banks engaged in international lending. Though there are a
number of federal laws concerning international banking, most are
procedural rules for the establishment of international oper-
ations. With the one exception of lending limits, it was not until
the passage of the International Lending Supervision Act of 1983
(ILSA) that broad supervision in the form of capital and collateral

150 Nationally chartered banks are granted the franchise and supervised by the Office
ines the affairs of the association and issues it a certificate authorizing it to do business as a
bank). The Board of Governors of the Federal Reserve System is concerned generally with
overall function and availability of credit in the United States. The Federal Reserve has
primary responsibility for the regulation of bank holding companies. See id. § 1842. The
FDIC examines all insured institutions, irrespective of charter or other agency supervision.
Id. §§ 1814-1816.

151 There is a tripartite system of federal bank regulation. In addition to the FDIC, the
National Bank Act authorizes the Comptroller of the Currency to grant national bank char-
ters and to examine those institutions periodically. 12 U.S.C. §§ 21, 26, 27, and 161
(1982); see also id. § 1814(b). The Board of Governors of the Federal Reserve examines all
state-chartered banks that are members of the federal reserve system, as well as all bank
holding companies. Id. §§ 221-228, 248.

152 See, e.g., 12 U.S.C. §§ 601-604a and 321 (United States establishment of foreign
branches); 12 U.S.C. §§ 611-631 (organization of corporations to do foreign banking); 12
U.S.C. § 1843(c)(13)(international banking facilities); 12 U.S.C. § 1843(c)(14) and 15
U.S.C. §§ 4001-4003 (export trading companies); 12 U.S.C. §§ 347d, 378, 601, 611a, 614,
615, 618, 619, 1813, 1815, 1817-1818, 1820-1823, 1828, 1829b, 1831b, 1841 (bank hold-
ing companies), 3101-3108 (foreign bank participation in domestic markets); and 12

153 12 U.S.C. § 84 limits the amount of loans a national bank may make to one bor-
rrower to 15% of the bank’s capital funds. The early regulations, 12 C.F.R. §§ 7.1310,
7.1320 (1977), did not address the unique situations found in international lending. For
example, the regulations made no mention of if and how banks were to combine loans
made to a sovereign with those made to private companies that were subsequently nation-
alized. Though the regulations were amended in 1979, they require combination only if
the borrowing entity fails to meet either of two tests—the means test or the purpose test.
The means test requires that the borrower have resources of its own, sufficient to service
its debt. The purpose test requires that a loan be obtained for a purpose that is consistent
with a borrower’s general business purpose. 12 C.F.R. § 32.5(d)(1)(i), (ii) (1987). Despite
its good intention, the regulations have not served to restrain international lending be-
cause there are usually enough separate entities in most countries to avoid banks having to
combine loans for purposes of the lending limits.

The exposure of nine money center banks to non-OPEC developing countries relative
to capital was 148 percent of gross capital. Review of the International Lending Supervision Act
of 1983, Hearing before the Subcomm. on International Finance and Monetary Policy of the Senate
Comm. on Banking, Housing, and Urban Affairs, 99th Cong., 2d Sess. 2 (1986)(statement of
William Taylor, Director, Division of Banking Supervision and Regulation, Board of Gov-
ernors of the Federal Reserve System)[hereinafter Subcommittee Review].

Ongman, Federal Regulation of Lending Abroad: Past History, Current Practice and Future Pros-
requirements and risk evaluation strategies came to exist. ILSA attempted to promote bank safety and soundness through increased requirements for bank capital, enhanced disclosure of sovereign lending to less-developed nations, and special reserves for value-impaired international debt.\textsuperscript{155} While all lenders must estimate the ability of a prospective debtor to repay its obligations, those creditors involved in sovereign finance must also assess the political stability of the borrowing nation. The very decision to lend becomes both an economic and political choice.

The anticipated high return on sovereign loans encouraged banks to lend without regard to political risks. Even when debtor countries were unable to accommodate their repayment schedules, the executive's supervisory agencies did not outline restrictions that would ensure against improvident measures by fearful banks. The executive's failure to exercise careful oversight has resulted in banks becoming less concerned about repayment and extending additional loans to permit countries to continue to make interest payments.\textsuperscript{156} Regulatory inaction has created a situation in which debt servicing by debtor countries averages approximately one-third of their gross national product.\textsuperscript{157} Many of the largest U.S. banks have single-country debt exposure equal to or greater than their equity capital.\textsuperscript{158} Sovereign responses to their repayment crises are also political acts that go beyond the scope of the U.S. judiciary's province to provide effective resolution of the debtor-creditor dispute.

The executive's stated position on international debt does not emphasize specific efforts designed to ensure safe and sound banking operations.\textsuperscript{159} The most recent administration statement on the

\textsuperscript{155} Ongman, \textit{supra} note 154, at 697-715. By and large, the most visible effect of the act has been to lead U.S. banks to expand their capitalization. \textit{Subcommittee Review, supra} note 153, at 2.

The act does not establish comparable limits on international bank activities such as lending limits to single borrowers, or rules requiring the aggregation of loans to a borrower. \textit{See} 12 U.S.C. §§ 84 & 85. Arguably, all of these efforts are too little too late. Worldwide debt of developing countries exceeds the $1 trillion dollar mark. \textit{World Bank, World Debt Tables VII (1987)} (projecting the total debt for all developing nations at the end of fiscal year 1987 at $1 trillion, 180 billion).

\textsuperscript{156} While appropriate criticism has been and should be leveled at bankers for lacking the prudence to take fewer risks in their sovereign lending, one should not lose sight of the fact that banking law required administrative supervision of these banks. Even if the tension between the private and public aspects of banking led to the lack of supervision in this area, the executive branch would have no excuse for its actions.


\textsuperscript{158} \textit{See supra} note 150.

\textsuperscript{159} A preferred policy would require: 1) internal economic adjustments by debtor nations to stabilize their economies; 2) International Monetary Fund intervention to assist in the redesign of economic programs and to provide short-term financing; 3) support from the governments of large creditor countries to assist debtors during the adjustment periods; 4) encouragement of further commercial lending to nations that implement IMF programs; and 5) encouragement of open markets and private-sector expansion. \textit{See Hearings
problem of international debt came from Treasury Secretary James Baker. Speaking at the IMF-World Bank meeting in Seoul, South Korea, in August 1985, Secretary Baker recommended: (1) commercial banks increase their debt exposure to the largest debtor countries; (2) development banks like the World Bank increase loan disbursements to debtor nations as well as guarantee direct investments; and (3) debtor countries make adjustments in their internal economies such as transferring inefficient state enterprises to the private sector, liberalizing trade practices, and loosening controls on foreign investment.160

While the Baker Plan emphasizes the interdependence of the world economy, it is woefully lacking in specifics. The plan does not address the likely effect of the IMF austerity measures on the political stability of debtor countries. Moreover, it does not address the relationship of the IMF and World Bank to the long-term development of debtor countries. Finally, and perhaps most importantly, the plan says nothing about domestic measures that will be taken to ensure the continued viability of U.S. banks. Asking banks to continue to lend to over-extended debtor nations with declining economies is irresponsible and specifically violates the congressional requirement that the executive act affirmatively to ensure a sound banking system.

To meet its legal charge of protecting public confidence, the executive branch either must intervene161 or be joined in problem international lending cases. Because adequate remedies cannot be fashioned without its participation, the executive is already a necessary party in any litigation involving sovereign loans.162 Given a basis to bring the executive into litigation, courts should then require detailed explanations of how problem international loans affect U.S. foreign policy. Because Congress envisioned and provided for executive action, courts have the power to assess administration responses to sovereign loan problems and, where necessary, order intervention.

Rule 19 of the Federal Rules of Civil Procedure requires the compulsory joinder of nonparties to avoid multiple suits and inconsistent verdicts.163 The rule provides that nonparties should be joined: (1) when complete relief without joinder cannot be accorded among those already parties in the suit;164 (2) when a nonparty's ability to protect an interest that is related to the case at bar, may be

---


162 See supra notes 11, 130-44 and accompanying text.

163 For the text of the rule, see supra note 12.

impaired unless the nonparty comes into the litigation,165 and (3) when a party in the litigation could be subjected to a multiple liability or inconsistent obligations unless a nonparty joins in the suit.166 Commentators most often explain compulsory joinder in terms of harm to the judiciary through multiple suits.167 In sovereign debt cases, it seems quite plausible that compulsory joinder could be explained in terms of potential harm to the political branches of government. Without government representatives sitting down to discuss a sovereign borrower's nonpayment of private debt, the prospects for harsh words between debtor and creditor as well as political embarrassment to U.S.-debtor nation relations are real. Moreover, the absence of the U.S. Government from any litigation involving sovereign debt could pose serious risks to monies directly owed the government by the same sovereign debtor. Therefore, a case for compulsory joinder can be made.168 Finally, the common-sense logic of bringing the executive into debt discussions cannot be disputed.

The Allied II court recognized that cooperative adjustment of international debt problems can be accomplished through the renegotiation and modification of the lending contract.169 What the court failed to understand was that effective restructuring can be realized only if the U.S. Government is made a party to the discussions.170 By permitting the executive to elect to remain out of restructuring talks, the possibility of effective problem resolution is reduced substantially. Further, executive discretion and forbearance endangers the safety and soundness of the domestic banking system. Contributions by the United States to organizations like the World Bank and the IMF are not substitutes for sovereign-to-sovereign discussions. The unique facts of sovereign risk lending make repayment problems a public issue and therefore demands direct participation of the government.

By bringing the executive into the forum, a court can discover, evaluate, and balance the national interests in foreign relations and in maintaining a safe and sound banking system with the needs of the

165 Id. 19(a)(2)(i).
166 Id. 19(a)(2)(ii).
168 For an interesting argument in favor of compulsory joinder for necessary parties in collective bargaining, see Rutherglen, Procedures and Preferences: Remedies for Employment Discrimination, 5 REV. OF LITIGATION 73, 103-15 (1986).
169 757 F.2d at 519.
individual plaintiffs. By crafting a remedy that requires the executive to designate representatives to participate in lending renegotiation sessions, courts not only recognize but also more easily accommodate both sets of competing interests. This limited review/remedy would not embarrass either of the other branches of government because the court would not have issued a ruling that would be contrary to stated policy. Executive intervention would permit the dissemination of more useful information on how certain decisions might affect not only the debtor-creditor relation but also U.S.-foreign sovereign relations. If a debtor nation had a better understanding of the possible responses a sister state might take should the debtor repudiate or default on its contractual obligations, the sovereign borrower might reconsider taking such action. The executive's broad abilities to give discretionary foreign assistance, to recommend and implement trade policies, to impose sanctions, and to influence other nations, all serve to make the executive a supermediator in debt talks. Like the political question doctrine, the act of state principle of extraordinary abstention in certain foreign affairs cases is unwarranted.

IV. Conclusion

If a dynamic approach to act of state analysis were adopted, the doctrine's goal of having the judiciary avoid inquiry into foreign affairs would not be met in a number of ways. Though courts would hear evidence of U.S. foreign policy as it relates to an international lending dispute, decisions would be directed toward the executive branch and not the foreign sovereign. By requiring executive intervention without adjudication, courts would not create foreign affairs problems by offending a foreign sovereign.

In Allied Bank, no Costa Rican assets located in the United States were attached nor did the court freeze any funds. Allied thus won a hollow victory. The executive's abilities to reach agreement with another nation on its private obligations enhances the possibility of real movement toward solving debt repayment problems. Executive branch presence in the conference room contributes to an atmosphere of cooperation in restructuring talks. The potential for divisive measures among different creditors would be reduced and coordination among creditors is strengthened.

Despite these positive prospects, executive branch participation still does not assure success. International debt problems will not disappear without hard work and sacrifice in both debtor and creditor countries. The probabilities of effective redress and continued international comity are heightened through executive participation, however. Unfortunately, the act of state doctrine has been used by the executive to avoid meeting the duties expected of it under fed-
eral banking statutes. By focusing their analysis on the domestic sovereign, courts can remain true to the doctrine yet offer aggrieved lenders a greater opportunity to resolve problem loans.