KEY POINTS
- After the imposition of capital controls in the debtor country, a local obligor may find itself sitting uncomfortably as a party defendant in a foreign court staring down the business end of a judgment issued by a foreign judge to pay foreign currency.
- In common law jurisdictions, parties to a contract may attempt to rely on one of three legal defences to excuse their performance under the contract.
- Few countries appear to have consciously drafted their capital controls in a manner that renders performance by the obligor positively illegal under the laws of the country imposing the controls.

Feature

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Contracts in a time of capital controls

Since the onset of the financial crisis in 2008, capital controls restricting the outflow of foreign currency have been imposed in a number of countries including Iceland (2008), Cyprus (2013) and most recently Greece (2015). While capital controls are hardly a new phenomenon, one largely unexplored aspect is the extent to which such regulations can be drafted in order to give corporate borrowers and counterparties in the debtor country a legal defence in foreign courts to the enforcement of their contractual obligations.

Capital controls come in two types: restrictions on capital flows *into* a country and restrictions on capital outflows *from* a country. Over the last 25 years, the former have been much more popular as a brake on "hot money" that can distort exchange rates and local markets, both on the way in and on the way out. The latter, however, are far more dangerous for inward investors. Restrictions on the ability freely to convert local currency investments into foreign currency and to remit that foreign currency abroad can lock an investor into an investment, or into a country, for far longer than originally anticipated.

PURPOSES

The principal purpose of controls on flows of capital out of the debtor country is to marshal and husband the pool of foreign currency within that country in order to safeguard the exchange rate and bolster the international monetary reserve position of the local central bank. Such controls will therefore ordinarily require residents to repatriate foreign currency held abroad (subject to exemptions for normal trade and investment) and will sometimes compel all residents to sell their foreign exchange up to the central bank in return for local currency. This places the central bank in a position to decide which obligations of residents to foreigners will be honoured because the central bank will either sell, or refrain from selling, the foreign exchange needed to pay the obligation.

The drafting of capital control legislation is, of course, entirely in the discretion of the government of the debtor country. In the 1980s, countries forced to restructure their sovereign debts occasionally used their capital control regulations to encourage private sector obligors in the debtor country and their foreign creditors to stretch out the repayment of private sector debts, thus easing demands on scarce foreign currency reserves of the central bank. The first program of this kind was instituted by the Mexican Government in 1983. It was captioned *Fideicomiso para la Cobertura de Riescos Cambiarics* and known by its acronym FICORCA. (See *Int'l Fin. L. Rev.*, July 1983 at 18.)

The Philippines promulgated two programs in the 1980s to encourage the restructuring of Philippine private corporate sector and financial sector debts. (See *Int'l Fin. L. Rev.*, Dec 1985 at 15.) These programs locked in a forward exchange rate for debtors, allowing them to discharge their obligations (on restructured terms) to foreign lenders by paying the local currency equivalent (at the guaranteed exchange rate) to the Philippine Central Bank which then assumed the obligation *vis-à-vis* the foreign creditor. The regulations encouraged the parties to the contract to agree a longer stretch-out by offering better exchange rates for more generous deferments.

THE POSITION OF LOCAL OBLIGORS

Capital controls can interfere with the commercial lives of local obligors in several ways. An obligation to tender to the central bank any foreign currency earned by the local enterprise may deprive it of the foreign exchange resources needed to service its obligations to offshore counterparties. A local obligor in this situation may be forced to rely on purchases of foreign exchange from the central bank (if the central bank is prepared to sell foreign exchange), or perhaps from the black market, to meet its contractual obligations. If the capital controls are accompanied – as they often are – by a devaluation of the local currency, the purchase of foreign exchange to service cross-border obligations will become increasingly expensive.

> A local obligor may ... find itself ... a party defendant in a foreign court staring down the business end of a judgment issued by a foreign judge to pay foreign currency.

Finally, although contracts governed by the law of the country imposing the controls (let's call it "Debtland") can be mandatorily redenominated into the local currency by an act of the local legislature, that power will not extend to contracts governed by foreign legal systems. A local obligor may therefore find itself sitting uncomfortably as a party defendant in a foreign court staring down the business end of a judgment issued by a foreign judge to pay foreign currency. That judgment will probably be enforceable against the obligor's assets and revenue streams located outside of Debtland, but enforcement in Debtland may be problematic.

> ... the existence of a capital control regime by itself [is unlikely] to give rise to a defence of impossibility or impracticality of performance ...

LEGAL DEFENCES

A local obligor caught in these circumstances will look for a legal defence to a contract enforcement action commenced in a foreign court. In common law jurisdictions parties to a contract may attempt to rely on one of the following legal defences to excuse their performance under a contract:

- *Impossibility* describes situations where performance of the contract is rendered impossible by supervening illegality, death or destruction;
- *Impracticability* is a modern variation of the traditional impossibility doctrine and applies to limited situations where performance is excused because of significant unforeseen expense or difficulty in performance;
- *Frustration of purpose* excuses a party where, although performance is not impossible or impracticable, the underlying purpose or object of the contract has been frustrated by a supervening event.

An overwhelming body of case laws makes it clear that a private sector obligor will not be excused from its performance merely because a devaluation of the local currency makes it more expensive for the borrower to service the obligation,[1] unless the increased burden on the obligor is extreme.[2] Nor is the existence of a capital control regime by itself likely to give rise to a defence of impossibility or impracticality of performance, even if those controls make it more difficult for the local obligor to source the foreign exchange needed to service its obligations.

In addition, the event giving rise to a claim of impossibility or impractically of performance must have been unforeseeable at the time the contract was executed and the risk of such an event must not have been explicitly allocated in the contract to one party or the other.[3] If the impractically resulted from the fault of one of the parties, that party may not plead it as a defence. In short, courts in common law jurisdictions have been remarkably reluctant to allow these doctrines to be used liberally to excuse performance of contracts.[4]

Thirty years ago in US courts borrowers located in countries that had imposed capital controls restricting payments in foreign currency attempted to argue that those controls constituted an "act of state" which should be respected by US courts. The act of state doctrine, judge-made law in the US, restrains US courts from inquiring into the validity of foreign governmental actions *if* (and this an important "if") the sovereign's action is taken within its own territory and is applicable there.

In the leading case of *Allied Bank Int'l v Banco Credito Agricola de Cartago*, the US Second Circuit Court of Appeals eventually (there was a tortuous procedural history to the case) decided that the Costa Rican capital controls at issue in the case were not entitled to deference under the act of state doctrine because the loans in question called for payments into US bank accounts and the borrowers had submitted to the jurisdiction of the New York courts. Accordingly, the Second Circuit reasoned, the geographical "situs" of the debt was not *wholly* located in Costa Rica and the act of state doctrine did not apply.[5]

ILLEGALITY

Few countries, however, appear to have consciously drafted their capital controls in a manner designed to give private sector obligors in the debtor country the greatest chance of surviving an attempt by a creditor to enforce the contract in a foreign court. The distinction here is between capital controls that make it more difficult or more expensive for a local obligor to perform a foreign contract (which will not normally be sufficient to establish a defence), and controls that purport to render such performance positively illegal under the laws of Debtland. A rough and ready essay at drafting the latter type of capital control law might come out as follows:

> Under penalty of law, no person subject to the laws of Debtland may, without the express written permission of the Central Bank of Debtland (i) hold foreign currency assets outside of Debtland or (ii) use (or acquire) foreign currency, whether in or outside of Debtland, to service contractual obligations to non-residents of Debtland. All foreign currency or foreign currency-denominated assets, wherever located, held or acquired by persons subject to the laws of Debtland shall promptly be sold to the Central Bank of Debtland at prevailing exchange rates for local Debtland currency.

A capital control law drafted in this manner might induce a common law judge to accept a defence of impossibility of performance. The capital control law above purports to make it positively illegal for a Debtland obligor to use foreign currency – whether sourced inside or outside of Debtland – to service foreign obligations. This arguably brings the matter within the "illegality" component of a contractual defence of impossibility.

In *Bank of Boston Int'l of Miami v Tefel*, for example, a US bank sued Nicaraguan nationals under a defaulted US dollar-denominated promissory note. The defendants raised as a defence Nicaraguan currency restrictions which barred residents from repaying loans in US dollars. In discussing this defence, the court relied on the fact that the defendants had been physically present in the US, and thus free from the Nicaraguan currency restrictions, for a

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number of years. The court spoke in these terms:

> "While it may well be the case that *were defendants still living in Nicaragua, an American court might be barred from requiring defendants to violate these restrictions by ordering that the debt be repaid in American dollars*, **because the [defendants] are now residents of the United States, those restrictions are irrelevant to this case."** [6]

In short, the fate of contracts in a time of capital controls may well turn upon whether the drafter of the capital control legislation is knowledgeable and far-sighted enough to use that opportunity to assist local obligors in establishing legal defences down the road. ■

1 See, eg *Bank of America Nat'l Trust and Savings Ass'n v Envases Venezolanos*, S.A. 740 F.Supp. 260 (S.D.N.Y. 1990), *aff'd sub nom., First Nat'l Bank of Maryland v Envases Venezolanos*, S.A. 923 F.2d 843 (2d. Cir. 1990) (loss of borrower's favourable exchange rate arrangement with the central bank increased the effective cost of servicing the debt five-fold; this increase was not enough to establish a defence of impossibility).

2 See, eg *Moyer v City of Little Falls* 510 N.Y.S. 2d 813 (N.Y. Sup. Ct. 1986) (intervening governmental action increased the cost of performing the contract by 666%; the court found that such "a massive cost escalation is 'excessive' as a matter of law and future performance . . . must be excused." Id. at 815.

3 See, eg *The Chase Manhattan Bank v. Traffic Stream (BVI) Infrastructure Limited*, 86 F. Supp 244 (S.D.N.Y. 2000) (a contractual definition of an Event of Default which expressly included events "effected by the operation of law or pursuant to . . . any order, rule or regulation of any administrative or governmental body" was held to allocate the risk of intervening governmental action to the borrower, precluding a defence of impossibility of performance).

4 See generally, RESTATEMENT (SECOND) OF CONTRACTS §261 (1981).

5 757 F.2d 516, 521 (2d. Cir. 1985) See generally, L.C. Buchheit, *Act of State and Comity: Recent Developments*, in JUDICIAL ENFORCEMENT OF INTERNATIONAL DEBT OBLIGATIONS (D. Sassoon and D. Bradlow, eds., 1987).

6 644 F. Supp 1423, 1426 (E.D.N.Y. 1986) (emphasis added).

Further Reading:

- Capital and exchange controls: limitations and implications [2012] 10 JIBFL 649.
- Effects of exchange controls introduced by an exiting Eurozone member state: the example of Germany [2012] 6 JIBFL 354.
- LexisNexis Financial Services: Understanding the issues around sovereign default.