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THE LEGAL RISKS OF EUROCURRENCY DEPOSITS

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Introduction

Eurodollar deposits are time deposits, denominated in U.S. dollars, in a bank or branch located outside of the United States. Although Eurodollar deposits have many features in common with domestic deposits, they do differ in one important respect: they are lodged with an entity in a different jurisdiction and are therefore affected by different laws, regulations and rules. Because of this, Eurodollars -- and their nondollar cousins, Eurocurrencies -- are looked upon askance by some who fear the sovereign risk of so-called offshore banking centers.

Empirically, Eurodollar deposits have long commanded a positive but variable premium over domestic time deposits. This premium has been explained both as a risk premium demanded by placers of funds and by cost considerations faced by issuers of liabilities.[1] Evidence suggests that, in recent years, the interest differential between domestic and offshore deposits (see Table 1) has come to be dominated by relative costs faced by issuers -- that is, by bank funding arbitrage.[2] If this is the case, then the demand function for Eurodollar funds by banks is horizontal, and any change in risk perception will reveal itself as a change in the relative stock of Eurodollars.[3]

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[1]For a comprehensive analysis of the economics of offshore banking, see Robert Z. Aliber, The Integration of the Offshore and Domestic Banking System, 6 Monetary Economics 509-526 (1980).

[2]See R. B. Johnston, Some Aspects of the Determination of Eurocurrency Interest Rates, Bank of England Quarterly Bulletin (March 1979), and Lawrence L. Kreicher, Eurodollar Arbitrage, Federal Reserve Bank of New York Quarterly Review (Summer 1982).

[3]This argument is pursued in Ian H. Giddy, Why Eurodollars Grow, Columbia Journal of World Business (Fall 1979) 54-60. Empirical support may be found in Gunter Dufey, W. Sung and S.R. Choi, The Growth of the Offshore Banking Market, unpublished working paper, The University of Michigan (1982).

Table 1

Mean and Variance* of Yield Spreads: Euro- vs. U.S. CD's
(in basis points)

	Three month Eurodollar	Six month Eurodollar	One year Eurodollar	Observations**
1974	74 (2554)	95 (1719)	96 (1555)	12
1975	40 (485)	51 (652)	45 (447)	12
1976	17 (97)	22 (193)	20 (201)	12
1977	22 (69)	20 (113)	12 (135)	12
1978	39 (470)	33 (493)	30 (929)	12
1979	54 (301)	44 (128)	29 (755)	12
1980	79 (839)	59 (699)	51 (336)	12

*In parentheses.

**First day of each month.

Source: Analytical Record of Yields and Yield Spreads, Salomon Brothers, Inc., N.Y., April 1982. Part IV, Table 2, pp. 1-3.

The purpose of this paper is to investigate the legal and economic foundations of the general risks faced by bank depositors, and analyze in a systematic way those risks that pertain to the onshore-offshore deposit risk issue. Specifically, we will discuss the legal and practical aspects of an international bank's liability for the deposit liabilities of its foreign affiliates under different circumstances. After identifying various actions that host and home governments can take against banks and their depositors, we will find that the risks of Eurodollars depend not only on the location of the bank and the disposition of its assets, but also on the corporate structure of the bank and even the residence of the depositors. We shall conclude that while the legal determinants of Eurocurrency deposit risk can be specified, one cannot state a priori that Eurodollars are more or less risky than domestic deposits, since it is not possible to place weights on how different depositors value different sources of risk.

The Economics of Eurocurrency Growth

Why does the volume of Eurodollars grow? To answer this, we should recall the three necessary, but individually not sufficient, conditions that explain the existence of an external market for intermediated credit. First, since all Eurocurrency transactions are international transactions from a legal point of view, a sufficient number of borrowers and lenders must be free to transfer funds internationally. Second, since the payment of Eurocurrency loans and deposits ultimately takes place through the clearing system of the country whose currency is being used to denominate the credit, nonresidents must have free access to clearing balances. Third, and most important, domestic banking must represent a cost disadvantage. Eurobanks must enjoy sufficient cost advantages to be able to reward customers for bearing the perceived risk of

engaging in banking in the "external" market. As stated before, Eurocurrency banking is always carried out in jurisdictions which provide Eurobanks with a systematic competitive advantage over those banks that pursue financial intermediation in a national market. The authorities of these "offshore centers" allow banks a great deal of freedom with respect to those credit activities that are denominated in foreign currencies, especially when the counterparts in the transactions are nonresidents, because such transactions do not affect domestic credit conditions. Thus systematic differences between national and external markets in the regulation of financial intermediaries are the decisive factors in explaining the reasons for the existence of the Eurocurrency market. The competitive advantage of Eurobanks is a result of the competitive disadvantages of banks in the national market.[4]

Of course, not all regulations create a competitive disadvantage for banks in national markets. For example, regulations promoting disclosure of financial conditions, and those activities of the supervisory authorities that further the safety of the institutions, will tend to attract depositors, and banks, to certain jurisdictions. Yet these are the exceptions. By and large, domestic rules and regulations tend to be a burden on financial intermediaries, since banking laws are frequently designed to further political and economic objectives other than the efficiency and security of the banking system. The unique character of Eurobanking is that it allows banks to choose among

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[4]The disadvantages arise almost exclusively from existing or anticipated banking regulations of the following types:

1. regulations which influence credit allocation of financial intermediaries;
2. regulations which burden financial intermediation activities with special costs (on this point one must add special assessments and taxes);
3. rules and regulations which limit interest rates on both deposits and loans;
4. rules and regulations which force intermediaries to maintain reserves which do not yield a market return;
5. all other rules and regulations which restrict competition among banks in one way or another.

jurisdictions. Since the banking authorities of offshore centers are thus in effect forced to compete with one another, the regulations that evolve tend to be those that favor banks and their depositors.

While relative regulation helps explain the Euromarket's existence, the disproportionate growth rate of the Euromarket is somewhat more difficult to explain. Table 2 shows that in every year since 1966, the net size of the Eurodollar market grew substantially faster than did the volume of domestic time deposits. Given the Eurobanks' competitive advantage, one would expect a migration of credit intermediation activities into the external market. However, having once achieved a new equilibrium, the external market should grow only pari passu to that of the respective national market. Thus, to explain the disproportionate growth of the Eurocurrency market, one must look for "dynamic" factors, that is, those that cause a change in the static competitive equilibrium.

One such factor is the effect of rising inflation on interest rates. As inflationary expectations increase, the level of interest rates tend to rise and with them the cost of certain banking rules and regulations.[5]

An argument can also be made that other burdens on domestic banks have increased, at least in some major countries such as the United States. For example, under provisions of "equal credit" laws and similar rules that restrict their asset choice, U.S. banks have been forced to accept credit

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[5]Legal reserve requirements are a case in point. Assume, for example, that banks must hold a no-interest legal reserve requirement of 5 percent against deposits. As interest rates move from 3 to 10 percent per annum, the opportunity cost to the financial institution increases from $0.15 to $0.50 for each $100 of deposits. This cost is normally passed on to depositors in the form of lower domestic deposit rates. When, as has happened in recent years, interest rates rise to 20 percent per annum, a domestic bank is forced to pay a full 1 percent less on deposits than offshore banks that are not subject to this disadvantage.

Table 2

Growth Rates of Onshore and Offshore Dollar Deposits

	Percent per annum	
Year	ETD	DTD
1964	-0.	-0.
1965	10.00	15.63
1966	36.36	8.11
1967	20.00	15.00
1968	38.89	10.87
1969	52.00	-4.41
1970	55.26	19.49
1971	20.34	18.03
1972	21.13	16.00
1973	34.88	16.61
1974	42.24	16.13
1975	18.18	7.18
1976	25.13	8.21
1977	18.03	10.98
1978	24.31	10.61
1979	20.67	9.92
1980	29.17	16.27

ETD: Stock of Euro Time Deposits, denominated in U.S. dollars; BIS data up to 1969; afterwards Morgan Guaranty Trust Co., World Financial Markets, various issues ("net" size of Euromarket, adjusted for nondollar content).

DTD: Domestic Time and Savings Deposits (all banks) from Federal Reserve Bulletin, various issues.

risks traditionally considered excessive. They have been called upon to finance local government entities experiencing fiscal difficulties, often at concessionary rates and terms. On the other hand, some changes in national markets have been in the direction of liberalization, and net effects are hard to determine a priori.

Third, for nonresident depositors, the legal status of domestic deposits may seem less secure. The U.S. freeze of Iranian deposits in the United States,[6] the activism of the tax authorities, and the discriminatory interest ceilings imposed on nonresident deposits in Germany and Switzerland are examples of actions that make European and Middle Eastern depositors, in particular, wary of domestic deposits.

In contrast, prior to the restrictions on U.S.-dollar-denominated deposits in banks located in Mexico,[7] there have been no problems with Eurocurrency deposits in the traditional offshore banking centers.[8] Indeed, the data on relative growth rates in Table 2 suggest a steady reduction in risk perceptions over time, a phenomenon consistent with the explanation that placers and takers of funds have become knowledgeable about the risks in the market. Still, risk perceptions persist and with them the question as to the rationality of the concern of Eurocurrency depositors.

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[6]The freeze of Iranian deposits was, of course, also extended to dollar deposits in foreign branches of U.S. banks. Whether the freeze order would ultimately have survived the legal challenges brought in the courts of the United Kingdom, France, and Switzerland is uncertain. The issue was rendered moot in January 1981 by the political settlement of the hostage crisis.

[7]The Mexican authorities deprived holders of dollar deposits in Mexican banks -- both residents and nonresidents -- of their right to obtain funds in U.S. dollars; instead they were permitted to make withdrawals only in Mexican pesos at the official rate of 69.5 Pesos per U.S. dollar at a period when the rate for Pesos outside of Mexico and in the black market fluctuated between 90 and 130 Pesos per U.S. dollar.

[8]There were no reports of dollar losses by depositors in Beirut banks except for occasional delays caused by the destruction of buildings and records.

Eurocurrency Risk Defined

Eurocurrency depositors conventionally assess their risk by looking, first, at the condition of the bank taking their funds. They also pay careful attention to the ability and willingness of the bank's central bank to play its role as a lender of last resort. The unique character of Eurocurrency deposits, however, lies in the interaction of four potential sources of risk: (1) the jurisdiction in which the banking entity operates, (2) the jurisdiction of the main office[9], (3) the country of residence of the depositor, and (4) the government that issues the currency in which the deposit is denominated. As a concrete example, a German resident may place his funds on deposit in the following ways: in mark deposits in Germany, or in a foreign jurisdiction such as Luxembourg (Euromarks); or in dollar deposits in Germany (his home country), in the United States (the home country of the currency), or in a third country such as Luxembourg.

Putting aside exchange rate risk, which will not be considered here, the first question a depositor should ask is whether the deposit is insured or otherwise backed up by the home government of the bank. The issue here is the willingness and the ability of the central bank to bail out the bank's depositors, which in turn depends on the government's policies on whether and how to support failing institutions. Assessment of the banking crises in the 1960s and 1970s has highlighted differences between countries' approaches and has produced some major changes. The U.S. and Japanese governments, for example, have consistently, although not explicitly, chosen to protect depositors at all

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[9] For purposes of this discussion, we assume that the "main office" is the headquarters of the bank, and that for purposes of domestic and international law, the location of the home office determines the "nationality" of the corporate entity. The "main office" is also the "parent bank" when speaking of its subsidiaries or affiliates.

costs.[10] In contrast, the German and Swiss authorities have at times allowed smaller institutions to fail in order to allow risk perceptions to function as a disciplinary force in the marketplace for deposits. Note that it is not necessary for the parent's central bank to be willing to support foreign branches. As we shall show later, the liability of a branch is also the liability of the parent, so that if a central bank supports the parent it is also effectively supporting depositors in foreign branches.

Whatever their policies, the ability of central banks to issue their own currency when necessary to back up deposits in that currency is unquestioned. No such assurance, however, is present when it comes to supporting deposit liabilities in foreign currencies. The ability of a central bank to obtain the necessary foreign currency funds is ultimately limited by its ability to mobilize domestic resources for foreign uses.[11]

If either the willingness or the ability of the central bank to back its deposits is not assured, the creditworthiness of the bank itself--the parent and all its affiliates--becomes relevant. While the bank's overall condition may be of significance to depositors, the focus of this analysis is not on bank solvency per se but on the fact that this risk depends on the location of the deposit and the residence of the depositor.

If the creditworthiness of the parent bank is not at issue here, then the relevant questions become (a) to what extent, if at all, does the legal entity

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[10]For the first time in postwar history, the U.S. authorities deviated from this policy in the case of the failure of Penn Square National Bank in 1982.

[11]For a review of the somewhat haphazard state of lender of last resort arrangements in an international context, see Richard Dale, Safeguarding the International Banking System, SUERF Colloquium, Vienna 22-24 (1982).

(e.g., branch) in which the deposit is made matter, and (b) does it matter if the entities are in different jurisdictions? To answer these questions it is necessary to draw upon several important legal concepts.[12]

Legal Entity Considerations: The Concept of the Corporate Person

Any depositor may place his funds with the main office of a bank, with one of its branches (at home or abroad), with a subsidiary or with an affiliate. In order to bring a corporation before the courts, the law has created what is known as a legal fiction: it has granted the corporation status as a "person" for purposes of law. This means that a corporation (and more specifically, a bank) can sue or be sued, make contracts, and have legal rights and obligations just as any individual. Once the corporation has been granted status of a "legal entity," it is also necessary to determine the residency of the corporation and to define the scope of entity for the purpose of the law. The residency determination was relatively easy, the place of incorporation and/or the location of the main office (it is thus possible for a corporation to have more than one legal residence--eg. a corporation may be incorporated in Delaware but have its main office in New York). The definition of the entity is also fairly well settled, including all operations of the corporation wherever located. In international banking this would mean that branches are part of the corporation, while subsidiaries and affiliates, which are themselves separate corporations, are not.

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[12]While the legal principles discussed below are generally applicable to international banking law as developed in the major countries, the specific cases and laws referred to will usually be U.S. examples.

The legal importance of this distinction cannot be overstated. The parent bank stands in the position of a shareholder in its subsidiaries and affiliates. Like an individual shareholder, the parent bank is liable for the acts of subsidiaries and affiliates only to the extent of its investment in the subsidiary or affiliate, absent some showing of fraud or gross negligence which equity would require imputing the liability to the shareholder. Thus, for most practical purposes, it can be assumed that the parent bank (main office) will not be legally responsible for the liabilities of its subsidiaries and affiliates.

Beyond the legal obligations, however, there are frequently business considerations that compel the owning firm to support the subsidiary's liabilities, even in the absence of an explicit guarantee. This factor is of special importance in banking, where a basic business purpose is to provide reliable depository facilities. In other words, these institutions are banking on their reputations.

In practice, in the context of international banking, the force of this moral responsibility has extended even to partially owned subsidiaries. There are several good examples from recent history. One is the case of United California Bank, which fully stood by the obligations of its (58-percent-owned) Swiss affiliate when, in 1970, it found itself in difficulties as a result of speculation in the cocoa markets.[13] By the same token, parent banks fully supported their consortium bank, Western American Bank (London), when that institution got into difficulties during the summer of 1974 in the wake

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[13]United California Bank Says Swiss Unit Incurred Losses That May Hit $30 Million, Wall Street Journal, 5 (September 8, 1970).

of the Herstatt affair.[14] Third, there is the interesting case of the Israeli-British Bank, where the parent organization headquartered in Israel defaulted on its obligations, but its London subsidiary (which was better managed) essentially paid off all its obligations, including Eurocurrency obligations, under Bank of England guidance.[15]

A somewhat different example of the extension of corporate liability to a partially owned subsidiary arises from a policy of the British authorities. In 1975, the Bank of England asked the parents of jointly owned consortium banks to accept pro-rata responsibility for the liabilities of their ventures.

Thus, a parent bank's effective responsibility for deposit and other liabilities extends to all bank affiliates irrespective of legal form. Nevertheless, the uncertainties associated with the subsidiary form are sufficient to force banks to pay a premium to attract deposits into subsidiaries. Banks therefore have little to gain from operating as subsidiaries and consequently -- in contrast to nonfinancial multinational enterprises -- conduct international banking primarily through branches.[16] The existence of subsidiaries in banking has to be explained by considerations other than insulation from liability. In the United States, for example, many banks house international activities in out-of-state Edge Act subsidiaries simply because this is the only permissible way to conduct international banking outside of their

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[14]London Bank Profits After It Becomes a Poor Credit Risk, Wall Street Journal, 27 (February 19, 1975).

[15]Joint Liquidation of Israel-British Banks Is Planned, Wall Street Journal, 22 (September 16, 1975).

[16]At the end of 1980, deposits in foreign affiliates of U.S. banks totaled $291.5 billion. Of this, 89 percent were in branches and only 11 percent in subsidiaries.

home state. Similarly, regulatory restraints cause international banks to operate abroad via the subsidiary form, despite the deposit-taking disadvantage.

Liability of the Home Office for Actions of its Branches[17]

1. The Relationship between Bank and Depositor.

When an individual, be it a person, corporation or other legal entity, deposits funds in a bank, domestic or international, it receives from the bank some evidence of that deposit, be it a receipt or, as is the case with some Eurocurrency deposits, a certificate of deposit. While this evidence is often in written form, it may be wire, telex, verbal, and, as electronics funds transfers become the accepted mode of transfering funds, simple identification of depositor and amounts in computer memory. No matter what form the transfer takes, however, the depositor transfers title to the funds from himself to the bank and receives in return the legal obligation of the bank to repay those funds in accordance with the terms and conditions of the agreement (contract) made between the depositor and the bank.

2. The Separate Entity Doctrine.

While a corporation is generally responsible for its legal obligations no matter where incurred, banking law has created an exception to the general rule known as the Separate Entity Doctrine.[18] The essence of this doctrine is that for many purposes, a bank's branch is regarded as a self-contained entity. This concept has been carried over into international banking by 12

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[17]This discussion and subsequent legal arguments are extensively reviewed in Patrick Heininger, Liability of U.S. Banks for Deposits Placed in Their Foreign Branches, 11 Law and Policy in International Business, 903-1034 (1979).

[18]Heininger, op. cit. pp. 931-935.

U.S.C. § 604 which provides that:

> Every national banking association operating a foreign branch shall conduct the accounts of each foreign branch independently of the accounts of other foreign branches established by it and of its home office, and shall at the end of each fiscal period transfer to its general ledger the profit or loss accrued at each branch as a separate item.

12 U.S.C. § 604 (1977).

In the past, this doctrine has protected banks and depositors in a number of instances.

First, creditors may not attach the deposits of a debtor in a branch of a bank by serving an attachment order on the head office or another branch, nor may home office deposits be reached by serving another branch, if the entities are in different court territories.[19]

Second, in court cases the home office of a bank may not be required to provide information about depositors in other branches.[20]

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[19]As one New York court said, "the law is settled that in a bank having many branches in diverse countries, an attachment of an account of deposit is valid only when made against the branch in which the account is held." Newton Jackson Co. v. Animashaun, 148 N.Y.S. 2nd 66, 68 (Sup. Ct. Nassau Co. 1955). However a Texas creditor recently got a federal court in New York to recognize that the main offices of banks now have complete computerized records. Thus orders served on main offices are just as effective as those delivered to the branches. Digitrex Inc. v. Johnson, 491 F. Supp. 669. See Therm-X-Chemical & Oil v. Extebank, 444 NYS 2D 26, 84AD 2d 787 (1981) which upholds the traditional role where the bank's operations were not computerized, but seems to imply that the rule is "obsolete" as far as banks having computer operations are concerned citing Digitrex, id. at 27.

[20]In light of Digitrex, supra, this proposition may not be as absolute as it was before. See also Cronan v. Shilling, 100 DYS 2d 474, aff'd 280 App Div 910 which states that: "if the local agency of a foreign industrial corporation, doing business in this state, were subpoenaed to produce here records of its home office, it could be required to do so. The local agency of a foreign banking corporation should be treated no differently.

Third, a U.S. court has also denied permission for a bank to offset a claim on someone in one branch against a deposit liability to that same person in another branch in another country.[21]

On the other hand, there have been significant cases in which U.S. courts have compelled banks to provide information and comply with attachment orders on deposits in their foreign branches in tax and bankruptcy cases.[22]

However, this does not mean that in every instance a bank will be protected from claims made against the home office for activities taking place at one of its branches. The home office still remains generally liable for deposits taken by its branches.

Should a branch run short of funds, a depositor may walk into the head office of the bank and expect repayment. In U.S. law, this principle has a long history of judicial support, dating from a 1917 incident in which Sokoloff, a Russian citizen, successfully sued a U.S. bank for repayment at the New York home office of his ruble deposit at the Petrograd branch.[23] The U.S. courts held that the Petrograd branch, in anticipation of nationalization by the Bolsheviks, had effectively ceased to operate without giving depositors a chance to withdraw their funds. The court decision in that case stated explicitly that the property and assets of branches belong to the parent bank, and that ultimate liability for the debt of a branch rests upon the parent bank.

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[21]Republic of China v. Nat'l City Bank, 208 F. 2d 627 (2d Cir. 1953).

[22]First National City Bank v. IRS, 271 F. 2d 616 (2d Cir. 1959) certden 361 US 498; and United States v. Omar, S.A., 210 F. Supp. 773 (S.D.N.Y. 1962) rev'd 321 F2d 14, rev'd sub nom. US v. First National City Bank 379 US 378 (1965). See discussion of these cases in Heininger, supra, pp. 935-941.

[23]Sokoloff v. Nat'l City Bank, 250 N.Y. 69, 80, 164 N.E. 745, 749 (1928).

More recently, a U.S. appeals court reaffirmed the principle of corporate liability by deciding that Chase Manhattan Bank in New York was responsible for piaster deposits in the Saigon branch when the branch closed in 1975, several days before the official takeover proclamation by the invading North Vietnamese revolutionary forces.[24] In the court's view, a bank is obliged to "inform its depositors of the date when its branch will close and give them the opportunity to withdraw their deposits, or, if conditions prevent such steps, enable them to obtain payment at an alternative location." The court went on to say that if such measures fail, fairness dictates that the parent bank be liable for deposits which it was unable to return.[25]

Interestingly, in neither decision did the currency of denomination of deposit enter into the court's decision, except insofar as an exchange rate had to be determined for repayment in U.S. dollars. Thus, the fact that a deposit in a foreign branch is denominated in local currency does not seem to exempt it from the principle of corporate liability.

The Concepts of Jurisdiction and Choice of Law and Forum

It is the exceptions to home office liability for foreign branch deposits which create the risks associated with Eurocurrency deposits. When a foreign branch of the home office does not honor its legal obligations--i.e. when a depositor seeks return of funds deposited with the foreign branch--the extension of a single corporate entity into two or more countries raises issues of jurisdiction and choice of law and forum.

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[24]Vishipco Line v. Chase Manhattan Bank, N.A., 660 F.2d 854 (2d Cir. 1981), appeal pending.

[25]Id. at 864.

1. Jurisdictional Questions.

There are two basic jurisdictional questions which are involved with Eurocurrency banking. Simply speaking, they involve the determination of which jurisdiction has legal control over the debt obligation owed the depositor and which jurisdiction will be able to hear and decide the controversy. These questions are often referred to as "choice of law" and "choice of forum" questions.

2. Choice of Law.

One thing in private international law is easily ascertainable, that is the fact that most courts will give effect to the principle that the law allows the parties to choose the law applicable to their contracts.[26] However when the parties do not choose, then the courts must look to other factors to determine the applicable law.

In cases turning on the conflict between laws governing a parent bank and those governing its foreign branch, courts have generally regarded the law of the country in which the branch is located as the controlling one. The basis for choosing which law applies in cases involving foreign branches lies in the fact that a contract has been entered into with a foreign entity within the jurisdiction of the country in which the branch is located. Thus, normally the "situs" of the deposit, i.e., the law of the foreign branch, will govern. However, if the deposit contract was associated with extensive contracts and negotiations in another country, then that country's law may apply.

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[26]Mario Guiliano, "La Loi Applicable aux Contrats: Problèmes Choisis," 158 Académie de Droit International, Recueil des Cours, 183 (1977). "L'analyse qui précède de constater que la solution d'après laquelle ce sont les parties elles-mêmes qui déterminent la loi applicable au contrat est actuellement la solution la plus largement retenue dans les systèmes nationaux de droit international privé." Id. at 199.

In the usual case of a deposit placement, where the payment is made in the home currency at the home office for a foreign "shell" branch without explicit documentation, there may be sufficient grounds to question the validity of any contractual stipulation of foreign law, because of the lack of any reasonable relationship with the foreign country.[27]

However, while general corporate principles support the theory that the home office of a foreign branch will be liable if that branch wrongfully refuses to pay,[28] this liability is not without limitation. In banking, the rule is qualified by the consideration that a bank's liability will generally be measured by the law of the jurisdiction where the foreign branch is located.

The U.S. courts have recognized a number of acts which have relieved the home office of liability for its foreign branches' failure to pay.[29]

3. Choice of Forum.

As with choice of law questions, the parties may agree upon a forum to litigate contractual differences, and U.S. and British courts, among others have given prima facie validity to such agreements.[30] But if the parties do not choose a forum, it becomes a question that has to do with whether a court will agree to hear a case or whether it will assert that the issue is beyond its jurisdiction. Resolution of this question often rests on whether the court is able to enforce a decision reached---for example, is the defendant present, or does he have assets that fall within the court's aegis and can be attached? In many cases involving claims and liabilities abroad,

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[27]Heininger, supra note 13, at 948.

[28]Heininger, op. cit. at 930. See also discussion at footnote 23, supra.

[29]This will be discussed in detail at footnote 37, infra.

[30]See Ingrid M. Farquharson, Choice of Forum Clauses--A Brief Survey of Anglo-American Law, 8 International Lawyer 83 (1974).

both American and British courts have claimed that they do have jurisdiction. Often they have done so because of the severe inconvenience or even impossibility of the plaintiff's obtaining a judgment in the foreign country.

Even when a case is heard by a U.S. court, however, the court will not necessarily apply U.S. law. Either the defendant or the plaintiff may argue that some foreign law applies, or the wording of the contract may suggest a choice of law.

Double Liability

A major tenet of jurisprudence, domestic and international, is that a court should not subject anyone to double liability in cases where laws conflict or overlap. Most courts are extremely reluctant to take jurisdiction over a case if there is another jurisdiction which also could claim the right to decide the case, if that court could (or would) rule contrary to the decision in the instant court. Thus in First National City Bank v. IRS, supra, the court, even though it ordered the bank to supply records from its Panamanian branch, indicated that if the bank could have shown that Panamanian law would prohibit such production, then it would not have ordered the production.[31] There are also dicta to the effect that the court would have declined to rule if the Panamanian courts had been involved. Although the court did not decline jurisdiction, it took care in ascertaining the applicable law of the jurisdiction where the foreign branch was located to determine the bank's obligations under that law.

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[31]See also, U.S. v. First National City Bank, 379 U.S. 378 (1968) which upheld the District Court decision in Omar, supra, footnote 22.

Relief from Liability--Sovereign Risk

The "sovereign risk" of Eurocurrency deposits arises from the general rule that if the foreign branch is relieved from liability, then the home office is also relieved from liability.[32] Essentially the determination of liability results from the application of the doctrine of sovereignty, and the recognition of foreign governments.

Even beyond the ordinary choice of law principles, the act of state doctrine may compel a domestic court to give effect to the laws and other acts of a recognized foreign government, even if the acts are contrary to international law or public policy. Thus, this is a further reinforcement of the principle of the choice of foreign law governing offshore deposits.

The act of state doctrine has been stated by the Supreme Court in a classical case, Underhill v. Hernandez, as follows:

> Every sovereign State is bound to respect the independence of every other sovereign State, and the courts of one country will not sit in judgment on the acts of the government of another, done within its own territory.[33]

The Supreme Court's rationale for this doctrine is based on the inherent nature of sovereign authority and the principles of international law. In Banco Nacional de Cuba v. Sabbatino, which dealt with the expropriation by the Cuban government of a boatload of sugar in Cuban territorial waters, the Supreme Court held 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...even if the complaint alleges that the taking violates customary international law.[34]

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[32]See Heininger, op. cit., pp 1009 et seq.

[33]Underhill v. Hernandez, 168 U.S. 250 (1897).

[34]Banco Nacional de Cuba v. Sabatino, 376 U.S. 398, 84 S. CT. 923 (1964).

The fact that the U.S. had severed relations with Cuba was not regarded as a valid basis for discussing the act of state argument---the Cuban government and therefore its laws were still recognized by the United States. Moreover, as Heininger argues, even when the foreign government taking the action is unrecognized by the U.S., it does not necessarily invalidate the act of state doctrine.[35]

Since the U.S. courts are disinclined to rule in areas which might conflict with the Executive Branch's foreign policy, the courts have in the past admitted an exception when the Executive Branch (through the State Department) has specifically stated that a particular action by a U.S. court would not interfere with the conduct of foreign policy.[36] In addition, recent court decisions have produced some doubt as to whether the act of state doctrine could be invoked if the conduct of the foreign government were of a purely commercial nature.

Indeed, both in the United States and in the United Kingdom, laws have been passed recently which adopt the "restrictive theory of immunity": governments are not immune from the jurisdiction of foreign courts insofar as their commercial activities are concerned. Thus if a foreign branch is seized and its liabilities appropriated as a result of a commercial dispute between the bank and the foreign government, and if the commercial

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[35]Heininger, supra note 13, at 973-987.

[36]Bernstein v. N.V. Nederlandsche - Amerikaansche Stoomvaart-Maatschappij, 173 F. 2d 71 (2d Cir.). A written statement of this kind from the Executive Branch is referred to a "Bernstein letter" or a "Tate letter." However, in a recent Supreme Court case that touched on the Bernstein doctrine, a majority of the justices rejected it.

activity has "substantial contact" with the United States, a U.S. court might not waive jurisdiction on grounds of sovereign immunity.[37]

In general, the following acts of a recognized government should relieve the home office of liability for the failure of its foreign branch to meet its legal obligations:

a) imposition of exchange controls, unless such controls violate a treaty signed by that government, or the deposit is outside the state imposing the controls;

b) moratoria or bank holidays;

c) disturbed conditions (civil war, etc.). This exception is not clear, but may temporarily relieve the bank from settling its liabilities;

d) seizure of assets (nationalization) with disposition of liabilities --as Heininger discusses, it seems unfair that the bank's liability to depositors should hinge upon whether the confiscating authority also included the bank's liabilities in its confiscating orders.

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[37]Under the Foreign Sovereign Immunities Act of 1976 (see 28 U.S. 1602 et seq.), sovereign immunity does not apply if the dispute results from an activity that is commercial in nature (but not necessarily in purpose), and which is carried on in the U.S.A., or has an effect on the U.S.A.

According to section 1605 of the act, jurisdictional immunity will not apply if, among other things,

1. the foreign state has waived its immunity either explicitly or by implication; or

2. the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States; or

3. if property has been seized in violation of international law and that property (or any property exchanged for it) is present in the United States in connection with a commercial activity carried on in the United States by the foreign state or one of its agencies.

Thus in international banking, the notion that the law of the jurisdiction of a foreign branch is the controlling one is regarded by many bankers as discharging a bank of liability in the event that foreign deposits are frozen by the local authorities. To a large extent, however, progress in technology and, as we shall see below, practical economics dictate otherwise. The advance of computer linkages and communications technology may well undermine the concept that a branch is a separate entity. If, in the future, more and more branches become mere "brass plate" entities consisting of no more than remote terminals and devoid of on-the-spot business activity, it is possible that the edifice constructed by the application of these doctrines will crumble.

Location of Assets versus Location of Liabilities

From a legal point of view, the choice of which law governs the liabilities has been firmly established: it is the law governing the branch of deposit. Yet these legalities tend to obscure the economic nature of deposits. In practice what matters to the depositor in the event of seizure is the location of the branch's assets.

The value of a bank or its branch is represented by its assets, not its liabilities. Thus, a government can gain only if, by seizing the branch, it acquires the economic benefits associated with the assets without passing them on to depositors. The focus on the seizure of deposit liabilities is economic nonsense, unless such seizure is accompanied by effective seizure of assets.

Indeed, the importance of the location of the assets has been recognized in U.S. court decisions, as the following statement of the Second Circuit Court in Menendez v. Saks & Co. exemplifies:

> For purposes of the act of state doctrine, a debt is not "located" within a foreign state unless that state has the power to enforce or collect it.

The truth of the matter is thus that in order to seize deposits in a bank one must also seize the bank's assets.[38] The question of whether deposits in a foreign branch were actually seized by a foreign government may therefore hinge on whether the government has also been able to take the branch's assets (or some other asset of the bank). While it has been suggested that the authorities of the confiscating country may sue the creditors of the bank in the courts of other countries,[39] little is likely to be gained from doing so. Foreign governments would probably not be recognized in the United States, and the courts of other major countries seem to be even less willing to support foreign confiscatory acts. In addition, international banks' loan agreements typically contain clauses allowing the bank to require payment at a different location.

On the other hand, the converse of this is not necessarily true. A government may seize a branch's (local) assets without seizing its local deposits. Asset seizure does not relieve the bank of its deposit liabilities, no matter what the cause.[40] It is therefore difficult for a bank to assert that an expropriation of assets relieves the bank of deposit liabilities.

Another problem is that while the act of state doctrine (sovereignty) will relieve the bank from liability in the instances enumerated above,

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[38]Thus Mexico's 1982 action on dollar deposits was completely effective only because dollar deposits in banks in Mexico were used to fund loans to Mexican borrowers.

[39]Mary Whitney Kenney, Expropriation of Offshore Branches of American Banks Located in Foreign Tax Havens, International Lawyer 286-293 (Spring 1980).

[40]The separation of depositors' claims from banks' assets is well established in the law. "The money deposited with the bank belongs to the bank and is not the property of the depositor" (in re Delaney, 256 NY 315, 319 [1931]).

normally the courts will not give like effect to acts taken by an unrecognized governmental authority. This fact is accorded recognition in the laws of New York and Michigan. In particular, section 138 of the New York Banking Law limits the liability of banks with New York home offices for contracts and deposits to be paid at their branch offices in foreign countries, when assets are taken by an unrecognized foreign government.[41]

The New York law arose out of international banks' concern that an unrecognized foreign government might, in Heininger's words, "relieve a bank of its assets without extending the courtesy of relieving [the bank] of its liabilities."[42] The law was thus originally intended to protect New York banks against the ambiguity of U.S. case law.[43] This protection, however, is a weak one. There is a thin line between acts of pure banditry and those of a self-appointed revolutionary government abroad. To the extent that the branch's assets are within the host country, the risk of seizure is passed on from the bank to the depositor; but the risk of pure robbery is not. Indeed, the law can be construed as giving protection to depositors. New York's section 138 implies that a bank cannot relinquish responsibility for the deposits of an offshore branch, even if the branch is seized, as long as it retains control over the assets of that branch.

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[41]The presumption here is that New York law would be regarded as governing, because the foreign government is not recognized as the sovereign authority. New York's banking law section 138 does not apply to acts of a recognized government.

[42]Heininger, supra note 13, at 1027.

[43]In Trujillo - M v. Bank of Nova Scotia, 51 Misc. 2d 689, 273 N.Y.S. 2d 700 (Sup. St. 1966), New York law was interpreted as protecting foreign banks in New York in the same way as section 138 protects American banks.

All or Nothing?

The discussion to this point has addressed the issue of a bank being completely relieved of liability for actions taken against its foreign branch. However, there are many cases where expropriation of assets is less than total. When a recognized host country government imposes exchange controls or other restrictions on deposits, whether in local or foreign currency, the bank would normally be expected to comply with them. In such a case the depositor would suffer a loss and have no effective claim on the home office, even if the assets were invested outside the host country. If the exchange controls are of a sufficiently comprehensive and permanent character, however, and if the assets are outside the jurisdiction (and therefore control) of the host government, then the bank can simply close the branch and relocate the situs of the deposits to a safer jurisdiction. Even then, the host government can seek to act against the depositors themselves, if they are within the country, or to take any of their property if any is present. The location of the depositor, as well as the deposit itself, is therefore of considerable importance.

New York banking law section 138(2) attempts to address this problem by allowing a bank to be relieved of the obligations of its foreign branch in proportion to the amount of its assets confiscated by the governmental authority. Thus, under this law, it is conceivable that if the branch which was confiscated or nationalized was merely a "shell" branch, there would be no relief from liability.

Private international law today has various diverse sources which reflect different rules of law in the international arena: treaties, conflicts

laws, state law and perhaps a little human or moral law.[44] However, to date there have been few cases involving international banking law. Perhaps this is just an aberration, or more likely, it is the result of the fact that there has been little need for litigation, since the system has worked relatively well and few governments wish to jeopardize their international financial position by confiscating assets of foreign banks having branches in their country. However, under the present state of the law, either the depositor recovers all or nothing and in some instances this might result in the bank obtaining a windfall.[45]

The Optimal Offshore Deposit

History demonstrates that sovereign risk comes in many guises. Governments may attempt to seize or freeze bank deposits or bank assets, if either lie within their territory. They may act to restrain the bank issuing the deposit, if the bank has its headquarters or other economic interests within their jurisdiction. They may act against the depositor himself, if he is unlucky enough to be present.

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[44]Philippe Malaurie, "Le Droit Monétaire dans les Relations Privées Internationales", 160 Académie de Droit International, Recueil des Cours 265 (1978). "Le droit international privé a audjourd'hui des sources diverse qui relèvent de methodes differentes, et cette variété est particuliérement perceptible quand il a pour objet des questions monétaires: traites . . . régles de conflits . . . régles unilatérales . . . et peut-être aussi un jus gentium nouveau indépendent des lois étatiques, ce qu'on appelle souvent la lex mercatoria . . . ." Id. at 276.

[45]Section 138 of New York's banking law represents an attempt to correct this situation, but to date there appears to be no court decision which accepts this principle.

It is possible to build a matrix of sovereign risks governing Eurocurrency deposits, and to select the combinations that minimize risk. Figure 1 presents such a matrix. Taking the perspective of a German depositor for illustrative purposes, it demonstrates fourteen hypothetical combinations: deposit at home or abroad, in the local or in a foreign currency, in a home, local or third-country bank. Without judging the relative reliability of each of the three governments, it is reasonable to suppose that depositing in a foreign currency, held outside the currency's country, by a third-country bank, minimizes the sovereign risk exposure. In addition, the depositor should ensure flexibility: the recipient bank should be able and willing to transfer the situs of the deposit at a moment's notice---which in turn means that the offshore branch should have little or no economic interest in remaining in the host country. The depositor himself should neither be present nor have any economic interests within the jurisdiction of the host country, the country of the currency, and the bank's home country.

One interesting aspect of this conclusion is that neither the stability of the local government nor the strength of the local economy has much bearing on the sovereign risk aspect of Eurodollar deposits. Quite the contrary---for a booming host economy would tempt offshore banks to develop an economic stake in it, reducing their flexibility to the peril of depositors.

As the freezing of Iranian dollar deposits has shown, sovereign risk can even arise from restrictions on the transfer of the currency underlying the Eurodeposit. A freeze of this type represents partial nonresident inconvertibility of the currency of deposit, and affects all depositors of a particular class, usually those from a certain country. This risk, however, may be minimized by holding deposits indirectly.

FIGURE 1

MATRIX OF SOVEREIGN RISK EXPOSURE FOR A GERMAN RESIDENT DEPOSIT HOLDER

	DEPOSIT	JURISDICTION (LOCATION) OF DEPOSIT INSTITUTION	HOME COUNTRY OF DEPOSIT INSTITUTION
DOMESTIC MARKET	DM	GERMANY	GERMANY NON-GERMAN BANK
EUROMARKET	DM	OTHER THAN GERMANY (E.G., LONDON)	GERMAN BANK BRITISH BANK THIRD COUNTRY BANK
FOREIGN MARKET	US$	UNITED STATES	U.S. BANK
EUROMARKET	US$	GERMANY	GERMAN BANK
EUROMARKET	US$	THIRD COUNTRY	THIRD COUNTRY BANK

NOTE: 14 COMBINATIONS ARE POSSIBLE, EACH WITH A DIFFERENT RISK PROFILE

A more serious risk is that of general nonresident inconvertibility, where all nonresidents, banks and nonbanks, lose the ability to transfer funds through clearing systems of the country of the currency. Even here the risk is not total. Assuming neither the depositor nor the bank has assets within the country of the currency in question, any offshore bank can employ a third currency to settle claims stemming from deposits and loans. In the ideal offshore deposit, a nonresident depositor would place hard-currency, freely transferable funds in a major, third-country bank branch located in a country with a favorable regulatory climate but an insignificant local economy.[46]

Concluding Remarks

Unfortunately or not, the vast majority of offshore deposits, upon examination, fall short of the ideal. Normally, when the action of a recognized foreign government falls short of expropriation or confiscation, and the bank wishes to continue operating in the host country, the separate entity doctrine exempts the bank from claims by depositors whose deposits are frozen by a foreign government. This doctrine, or in general the notion that the foreign government's law takes precedence, has had a powerful effect on international banking practice and on the folklore of deposit taking.

In our view, too much has been made of this doctrine and its consequences in terms of the susceptibility of depositors to interference by host country

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[46]Some observers have supposed that the introduction of an onshore deposit facility free of reserve requirements -- the so-called International Banking Facilities introduced in December 1981 -- would attract funds from the Eurodollar market because of lower perceived sovereign risk. The preliminary evidence, however, does not support this prediction. Data suggest that much of the growth of IBF deposits has been at the expense of other domestic deposits. Moreover, IBF deposits bear the same interest rate as offshore deposits -- so far, no "risk discount" has appeared. See Sydney J. Key, Activities of International Banking Facilities: The Early Experience, Federal Reserve Bank of Chicago Economic Perspectives, 37-45 (Fall 1982).

authorities. Sovereign authorities must be respected, but an international bank has a corporate responsibility to protect its depositors against those risks, including sovereign risk, over which it has some control. A foreign branch, as a legal entity, is subject to local laws. However, a global bank does retain substantial control over the extent to which its depositors are subjected to sovereign risk. Neither imposing controls on deposits nor expropriating the whole branch will necessarily yield control over outside assets to the host government. Indeed, it would take a very special constellation of political affiliations to produce such results.[47] Whenever a branch holds its assets outside the local jurisdiction, the parent bank has the option of relocating the situs of offshore deposits very quickly, particularly when deposit agreements provide for such contingencies in advance.

The flexibility which international banks realistically have, when juxtaposed with their profound reluctance to make any statement about their corporate responsibility for offshore deposits, provides disconcerting evidence of a moral hazard issue. Are foreign branch managers perhaps investing Eurocurrency funds in such a way as to transfer political risk onto depositors? This point can be illustrated with an example. Certain U.S. banks have been quite successful in attracting dollar deposits from neighboring countries to their Uruguay branches. Where should such funds be employed? If the funds are invested locally, i.e., in Uruguay itself, the bank might be afforded some protection because under current law it is possible to offset seized assets with deposit liabilities, at least for banks with New York offices. However, this

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[47]As an illustration, consider a hypothetical case in which the government of the Cayman Islands was taken over by Communist forces; in this case the new rulers would be able to collect, at best, only the loans made by branch banks in the Cayman Islands to Socialist countries.

is exactly counter to the interest of the depositors, whose very intent in placing the funds offshore was to guard against domestic expropriation, forced currency conversion, and similar potential actions that afflict savers in countries with unstable political conditions. The responsible banker will invest outside deposit funds in outside assets.

The question can therefore be rephrased as one that involves the legal as well as the moral responsibility of an international bank. Since such a bank has the option of safeguarding deposits (albeit by losing the "political hedge" on its assets), does it not also have the responsibility to do so? Moreover, should the international banker not be bound by a principle of "truth in deposit risk?" For instance, should not international banks inform depositors about the extent to which funds are invested inside or outside of the country where the branch does business?

A final irony arises from these legal complexities. It is evident from the above that the depositor's position is most precarious if the branch's host government takes relatively mild actions, such as exchange controls or the imposition of taxes on existing nonresident deposits. In such cases, local jurisdictions prevail. In contrast, when there is a total seizure of the branch, particularly when (as in Vietnam) branch managers find themselves forced to close shop and flee, the depositor's primary claim reverts to the parent bank. The difference is that in the first case the bank has a continued interest in operating in the host jurisdiction; yet continued operation may imply acquiescence to governmental actions that are detrimental to their depositors. If the depositors' interests claim first priority, the bank would simply relocate the branch, with its (outside) assets and liabilities intact,

to another jurisdiction. Banks have seldom informed Eurocurrency depositors of this expedient, perhaps for fear of jeopardizing their relationships with host governments. At the end of the day, however, their responsibility is to depositors, and if they do not now acknowledge their ability to protect depositors' interests in this manner, they must eventually be forced to do so--either by the courts or by the force of competition.

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