

Eurozone Bulletin: Capital and Exchange Controls

Executive summary

The Cyprus bail-out/bail-in package involved the first capital controls to be imposed in the eurozone. If the tensions in the eurozone continue, further capital control measures are possible. If an actual eurozone exit ever occurs, such measures are likely to be particularly wide ranging in the exiting state, other economically weak states, and probably also (in the shape of controls over inflows) in stronger states.

Capital controls can take a wide variety of forms and generally form part of a wider economic package. Historic examples of, for example, Argentina and Malaysia, and the more recent cases of Iceland and the Ukraine, provide useful precedents when trying to forecast the scope and shape of any future controls.

The legality of capital controls is constrained, for member states of the EU, by the TFEU, and, for almost all countries, by the Articles of Agreement of the IMF. It is unclear whether the Cypriot controls fall within exemptions set out in the TFEU, but the European Commission has published a statement opining that they do – although that seems, in part, to rely on the controls not being extended in duration. In any event, it is the ECJ rather than the Commission that is the arbiter of such matters. The IMF have made a statement of "full support" for the package that includes the controls, which appears to bring them within a safe-harbour set out in the IMF Articles, at least for the present.

Capital controls can raise many issues of conflict of laws, in particular regarding the enforceability of contracts the performance of which would involve breach of such controls. In summary, such performance will not be enforced by the courts of the imposing state, nor by the courts of England (and many other jurisdictions): (i) where the governing law of the contract is that of the imposing state; (ii) where the place of performance of the contract is in the imposing state; or (iii) where the contract is an "exchange contract" for the purposes of the IMF Articles (the definition of which is highly technical, and is construed differently in different jurisdictions).

In other circumstances, the contract will generally be enforceable, potentially leaving one or both parties in the unattractive position of being open to civil or criminal sanctions in the imposing state (assuming they have some presence there on which such sanctions can bite).

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Capital controls in the eurozone

In our June 2012 Eurozone Bulletin entitled “*Updating Contingency Plans*” we referred to the likelihood that any state exiting the eurozone (referred to in this Bulletin as an “exiting-State”) would also announce various capital and foreign exchange controls with the aim of preventing a flight of funds from, and/or the collapse of, its financial system. Last week, Cyprus became the first eurozone member state ever to introduce capital controls – albeit not (yet, at least) as part of a eurozone exit, but rather as a consequence of the conditions underpinning the €10bn EU-IMF bailout intended to stave off such an exit.

This Bulletin identifies the potential range of capital and/or exchange control measures which European states, both inside and outside monetary union, could seek to introduce in light of the economic difficulties persisting within the eurozone (these states being referred to in this Bulletin as “imposing-States”). The introduction of such measures could arise, as in Cyprus, in response to measures aimed at the imposing-State’s continued participation in the eurozone, or indeed in connection with a state’s exit from the eurozone. Drawing upon the experiences of countries that have imposed capital controls over the last century, we also identify the key legal issues - both the legality of such controls and the related issue of the enforceability of contracts impacted by these controls – which may arise in both scenarios.

What are capital and exchange controls?

Capital controls are measures taken by a government, central bank or other regulatory body of a country to regulate or limit the flow of foreign capital into, and/or out of, the domestic economy. These can, technically, be distinguished from measures which regulate ‘current’ transactions such as payments in connection with foreign trade and business, services including short-term banking facilities and the payments of interest or income generated from capital investments – current transactions tend to be subject to less stringent (if any) controls. We note, however, that the term “capital controls” is often used broadly to encompass measures which regulate ‘current’ transactions, and the term is used in this sense in this Bulletin.

Capital controls can seek to limit both capital outflows and capital inflows:

- > Capital *outflows* occur where a country purchases assets (including making deposits in foreign bank accounts), makes loans to the rest of the world and/or when external investors in that country liquidate their investments and repatriate the proceeds. Controls on capital outflows are today commonly accepted as a legitimate response to (or anticipatory measure with regards to) a financial crisis in order to prevent – or slow down – capital flight, runs on domestic banks and general financial destabilisation. Cyprus has sought to introduce a range of controls, including limits on depositors’ cash withdrawals, cross-border movements of cash and overseas credit card transactions, for exactly this purpose. The IMF, within limited

Summary of capital controls introduced in Cyprus

A capital and exchange control law was passed in Cyprus over the weekend of 23 March 2013.

The banks in Cyprus were shut from 15 March until 28 March. In advance of the re-opening of the banks, the Cypriot Minister of Finance issued a Decree containing various capital controls regulating both the size and the amount of money permitted to be withdrawn.

In summary, these are as follows:

- Individuals cannot withdraw more than €300 per day from any one bank.¹
- **Cheques cannot be cashed,**² unless they were issued by a bank in another country (however, cheques may be deposited).
- The transportation of euro banknotes or foreign currency in excess of **€1000 (or equivalent in foreign currency) per person per trip abroad** is prohibited. This measure is to be enforced by customs officials in Cyprus.
- Non-cash payments or money transfers **outside Cyprus** are prohibited unless:

(a) they are payments for **commercial transactions within the ordinary activities** of the payer (for example, Cypriot importers) who must present documentary evidence. Payments from €5,001³ to €200,000 must be approved by the central bank of Cyprus, which will consider the liquidity of the bank involved and make a decision within 24 hours. Payments above €200,000 will be decided upon on a case-by-case basis;

(b) they are for payroll purposes, and supporting documents are presented;

(c) they are for living expenses or tuition fees of students who are close relatives of Cypriot residents. Transfers for living expenses are capped at €5,000 per quarter, and supporting documents must be supplied; or

¹ any part of the daily limit not used may be withdrawn at any time afterwards.

² as of 3 April 2013 payments through cheques to accounts held in other banks up to €9,000 per month per person can be made.

³ this figure was increased from €5001 to €25001 on 3 April 2013 in respect of transfers to another bank.

parameters, now endorses the use of capital controls in appropriate circumstances of crisis, reversing its earlier rigid stance adopted in the 1980s and 1990s against such measures.

- > Capital *inflows* occur where the rest of the world is accumulating net claims on, or investments in, a country (that is, where the country is selling assets or is in a net-borrowing position as regards the rest of the world, or when residents of that country are liquidating assets abroad and repatriating the proceeds of liquidation). Controls on capital inflows seek to avoid damage to a nation's economy from large capital inflows causing its currency to appreciate, contributing to inflation, and/or causing unsustainable economic booms which are often sharply reversed.

"Exchange controls" are a sub-set of capital controls and comprise a range of possible measures which seek to control the relationship between domestic and international currency markets – that is, they control the purchase/sale of foreign currencies by residents and/or the purchase/sale of local currency by non-residents of the imposing-State.

Relevance of capital controls

We have seen in Cyprus the imposition of capital controls in the context of a eurozone country adopting measures, supported by international assistance, aimed at reinforcing its economy and maintaining its membership within the eurozone. These wide ranging controls seek to prevent or limit transactions which would otherwise result in outflows from Cyprus's banking sector, and its economy more widely. To date, there appears to be no suggestion of other eurozone countries – whether having strong or weak domestic economies – introducing measures in response to Cyprus's actions. However, it remains possible that other eurozone states may resort to imposing capital controls in future should they themselves have (in some instances, again) to seek assistance from international bodies in propping up their struggling economies.

If an actual eurozone exit occurs, an exiting-State would almost certainly impose capital controls as a means by which to prevent, or control, outflows of capital from its territory, and its banking sector in particular. It also seems likely that, in such a situation, *other* states would also impose controls in an attempt to protect their economies from the fall-out this would bring:

- > EU Member States considered to be vulnerable to contagion-risk could impose similar controls on outflows of capital from their territories as investors and depositors seek to withdraw capital through fear of further exits.
- > States which, whether or not they are in the eurozone or indeed the EU, are considered to have relatively strong economies (for example, Germany, Switzerland and Denmark) could seek to restrict *inflows* of capital into their economies from both the exiting-State and those EU Member States which are considered vulnerable to contagion-risk.

(d) they are for credit or debit card payments (in which case payments are capped at €5,000 per month). Credit and debit card payments *within* Cyprus remain unrestricted.

- Term deposits: where money is deposited in a bank account for an agreed period, it cannot be withdrawn early, unless the money will be used to pay off a loan to the same bank or put in another fixed deposit account. On the maturity date, the greater of €5000 or 10% of the total amount deposited can be transferred, at the choice of the depositor, to either a current account or new fixed term account at the same bank. The remaining funds are subject to an extended maturity period of one month.
- Financial transactions, payments or transfers that have **not been completed prior to publication of the decree on capital controls will be caught** by the restrictions.
- Banks cannot make non-cash payments or money transfers that circumvent the capital controls.
- The restrictive measures **apply to all accounts**, payments and transfers, **regardless of the currency**, except that they do not apply to payments by the Republic of Cyprus or the Central Bank of Cyprus.

The ministerial decree containing the capital controls states that the restrictions shall apply for a period of seven days from first publication. However, it is likely that this will not be a sufficient period of time and it is expected by many that the government will renew the restrictions on a weekly basis for as long as is necessary.

There are a number of material questions raised by the Cypriot capital restrictions where the position is currently unclear, including:

- the effect of the restrictions on contractual rights of set-off, collateral and proprietary or security interests; and
- the potential liability of a bank for failure to discharge a customer's obligation because of its compliance with the restrictions.

- > EU institutions could also seek to impose EU-wide temporary capital controls as against non-EU Member States in an attempt to maintain the operation and stability of the economic and monetary union.

Scope of capital controls

History illustrates the potential breadth and far-reaching effects of any capital controls which an imposing-State might introduce, whether in connection with its continued participation in the eurozone, or indeed its (or another state's) exit from the eurozone. These are summarised in the box to the right, with further discussion below.

Modern examples

The diversity of capital control measures imposed in the age of international financial markets is apparent from the experiences of Malaysia in 1998, Argentina in 2001/2 and particularly Iceland in 2008, as well, of course, as Cyprus itself. In many instances, capital controls have been used as one mechanism within a range of economic policies imposed in an attempt to avert, or recover from, economic downturns. For example, Malaysia in 1998 not only imposed sweeping controls on capital-account transactions, it also pegged the ringgit to the US dollar at a fixed exchange rate, cut domestic interest rates and ordered repatriation of all ringgit held overseas. Argentina in 2001/2 restricted (among other things) cash withdrawals, the purchase and transfer of foreign currency overseas and the payment of dividends, all alongside its sovereign default and the subsequent devaluation of the peso, abandoning parity with the US dollar in January 2002. These precedents show that, as we have seen recently in Cyprus, it is likely that any capital controls in response to the eurozone crisis will comprise just one part of a range of measures which eurozone states may seek to introduce in order to manage their economies in times of economic difficulties, and in the period following any possible eurozone exit.

Practical issues in relation to capital controls

Practicalities of implementation

Capital controls are most likely to be introduced, as in Cyprus, without prior announcement and accompanied by the declaration of one or more public holidays in the imposing-State. Neighbouring states, especially those also considered to have weak economies vulnerable to 'contagion risk', may similarly consider it necessary to declare public holidays in order to avoid a run on deposits held in their banks – whether by nationals of the imposing-State holding accounts there, or by its own nationals concerned that similar controls may follow in that state too.

The economic uncertainty accompanying, and often underpinning, the introduction of capital controls, can lead to runs on deposits – to varying degrees, and within any permitted daily limits – when banks reopen. The co-ordination of international and governmental bodies can be required to ensure the availability of physical cash needed to meet those demands. It has been suggested, for example, that the ECB delivered additional banknotes to

Potential scope of capital control measures:

- outright prohibitions on certain types of financial or other transactions;
- quantity restrictions on the amounts of currency (whether foreign or domestic) permitted to be taken across international borders;
- "minimum stay" requirements which prevent the divestment of investments during a specified holding period;
- "mandatory reserve" requirements which oblige a party to deposit a percentage of certain capital inflows into a bank account with a central bank for a minimum period of time;
- the freezing of bank accounts;
- the compulsory conversion of currencies;
- restrictions on borrowing, lending and the granting of guarantees between domestic and foreign parties;
- administrative procedures – for example, requirements for reporting to central banks or obtaining governmental approval;
- transaction taxes; and/or
- "exchange controls" potentially comprising:
 - restrictions on the buying/selling of a national currency – whether absolutely, or at what would otherwise be the market rate (i.e. by imposing fixed exchange rates);
 - the requirement for the purchasing and selling of foreign currency to be executed through a government body or specifically-authorised intermediaries;
 - the banning of residents/nationals from possessing foreign currency;
 - the banning of the use of foreign currency within the country; and/or
 - the controlling of residents'/nationals' use of foreign currency abroad (for example, where money is already abroad).

Cypriot banks in anticipation of their reopening. There is a need, however, to control not only the withdrawal or transfer of cash, but also the making of electronic transfers and the cashing of cheques issued on accounts held with domestic institutions.

Imposing-States also have to determine how financial transactions, payments and/or transfers that have not been finalised prior to the imposition of the capital controls will be subjected to the restrictive measures. Whilst it should be noted that different imposing-States could each resolve this issue differently in future, the Cypriot measures provided that such transactions were cancelled – requiring them to be resubmitted and, therefore, subject to the limits and restrictions imposed by those measures.

Territorial scope and limits on the potential scope of exchange controls

Capital control rules rarely attempt to impose the controls solely within the jurisdiction of the imposing-State and instead generally seek to apply the controls extraterritorially. Of course, the task of imposing capital controls within the eurozone is complicated by the fact that the euro is the lawful currency of many other states, and so controls based on the currency of transactions will not work. Indeed, it is notable that the capital controls Cyprus has imposed appear to have had the result that a euro in Cyprus is worth less than a euro elsewhere.

Avoidance and methods of enforcement

People have always sought to circumvent capital controls, as a result of the substantial commercial incentives in doing so. As such, the rules which introduce capital controls are often originally drafted very broadly with limited specified detail as to their application, with the rules subsequently amended to close down loopholes being exploited and to clarify the scope of the initial measures – this was, for example, the case in Iceland and can be expected in the case of Cyprus should its measures remain in effect for an extended period of time (the possibility of which is discussed further below).

The means by which measures are enforced will depend largely upon the nature of the capital controls being imposed. Enforcement has often been achieved by a combination of both civil and criminal sanctions. The central bank of an imposing-State may well be tasked with administrative / supervisory roles, and a state may also deploy its military at frontiers where restrictions are put in place preventing the cross-border movement of physical money. Historically, sanctions for breach have ranged from fines or increased supervision by state entities, to the removal of banking/trading licenses or even imprisonment for those persons involved. The Cypriot controls provide for the criminal liability of natural persons who breach them, with penalties including fines (not exceeding double the value of the unlawful transaction) and possible imprisonment. Civil sanctions apply to breaches by non-natural legal persons – including the imposition of administrative fines, and the possible suspension or revocation of banking licences – together with civil fines for any directors, officers or employees of such entities committing such breaches by reason of their fault, negligence, or wilful misconduct.

Legality of capital controls

The legality of an imposing-State's capital controls, as a matter of international law, may be constrained by applicable laws and treaty obligations arising by virtue of, among other things, its membership of the EU and the IMF and its entry into bilateral investment treaties.

EU law restrictions

EU Member States are bound by the general prohibition on restrictions on the movement of payments and capital between EU Member States and between EU Member States and third countries (i.e. non-EU Member States) as set out in Article 63 TFEU¹.

The European Court of Justice has interpreted widely the concept of what constitutes both a "movement of capital" and a "restriction" on such movement, providing Article 63 with a potentially wide-ranging effect.

The TFEU provides for a number of exceptions from the requirement for the freedom of payment and capital movements, the most relevant of which are as follows:

- > **Article 64(3)** provides for the EU Council, acting unanimously in accordance with the special legislative procedure and after consulting the European Parliament, to adopt measures which "*constitute a step backwards in Union law as regards the liberalisation of the movement of capital to or from third countries*". This provision is unlikely to be relevant to a country seeking to unilaterally impose capital controls in the face of economic difficulties, although it could possibly be relied upon if the eurozone as a whole were to face a more substantial deterioration in economic stability.
- > **Article 65(1)** provides that the Article 63 prohibition is without prejudice to the right of a Member State to "*take measures which are justified on the grounds of public policy or public security*". These measures may not, however, constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments (**Article 65(3)**). (This exception is discussed further below.)
- > **Article 66** provides for a mechanism by which the EU Council may take safeguard measures, lasting up to six months, in respect of capital movements to or from non-EU Member States which "*cause, or threaten to cause, serious difficulties for the operation of economic and monetary union*". The applicability of this provision relies on what is a generally lengthy process, involving an initial proposal from the European Commission and subsequent consultation with the ECB, the duration of which reduces its potential effectiveness. However, we note that there may be scope for accelerated action on the part of the EU institutions in this regard. This provision – and its limited scope of application, as set out above – has been much misunderstood in recent commentary, including by Capital Economics in their 2012 Wolfson

"1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

Article 63 TFEU

"1. The provisions of Article 63 shall be without prejudice to the right of Member States:

...

(b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security."

Article 65(1)(b) TFEU

¹ Treaty on the functioning of the European Union

Economics Prize winning article, “*Leaving the Euro: A Practical Guide*”, where it is wrongly suggested that it might provide grounds for a state itself imposing capital controls.

- > We consider it most likely that an imposing-State in the EU would, in each of the various scenarios considered in this Bulletin, seek to rely on the permitted derogation contained in Article 65. The ECJ has previously sought to emphasise the limited scope of this derogation, providing that “*the general financial interests of a Member State... [and] ... economic grounds can never serve as a justification*”. Instead, there must be “*a genuine and sufficiently serious threat to a fundamental interest of society*” with the imposing-State’s measures being a ‘necessary’, and not overly-restrictive, response to this threat, whilst observing the principles of non-discrimination and proportionality throughout. However, despite these restrictive interpretations, the significant financial chaos and potential civil disorder resulting either from extreme economic difficulties or, at worst, a eurozone exit, may provide a state with an arguable case for asserting a broad interpretation of Article 65 as a means by which to justify the imposition of temporary capital controls.

Iceland’s capital controls in 2008 provide a useful precedent here in the context of severe economic troubles (although still an imperfect one as Iceland was not, of course, a participant in the euro). Iceland’s attempts to limit the outward flows of capital it was experiencing in 2008 were upheld by the EFTA Standing Committee under Article 43 of the Agreement on the European Economic Area (the “**EEA Agreement**”) (akin to Article 65 TFEU) as being compatible with its treaty obligations under the EEA Agreement which are, for these purposes, similar to those under the TFEU. One gloss on this, however, is that it has been argued that Iceland’s capital controls sought to discriminate between domestic entities and foreign entities (for example in connection with the different treatment of interest payments on certain bonds) and so to that extent should not have been upheld. This should be borne in mind when assessing the soundness of Iceland’s capital controls as a precedent, and the potential legality of any measures enacted in reliance on the Article 65 TFEU derogation.

We note that the European Commission in its statement of 28 March 2013 assessed the controls currently in force in Cyprus as being justified by the overriding public policy of stabilising the Cypriot banking system and the financial markets (presumably therefore arguing that the controls fall within Article 65 TFEU – the statement refers to “Article 63 et seq” of the TFEU). However, this analysis appears to rely heavily on the measures being temporary, and stated to be in force only for seven days. Given the experience of other countries’ controls having remained in force for many years, despite initially having been introduced as short-term temporary measures (Iceland and Argentina being particularly pertinent examples in this respect), it seems quite possible that the Cypriot controls will be extended in duration; indeed, it has been suggested that the Cypriot government may look to renew them on a weekly basis “for as long as necessary”. With each such

extension, the ability to justify the measures as truly ‘necessary’, within the strict confines of the Article 65 derogation, may become ever more difficult. In any event, it is of course the ECJ, and not the Commission, that is the arbiter of the scope of Article 65, and so the Commission’s statement is by no means conclusive, even as far as it goes.

In the particular context of a possible future eurozone exit, it remains to be seen whether a state’s unilateral exit would impact upon the ability of that exiting-State to rely on its exit as a means of justifying its capital controls within the scope of the Article 65 derogation. This is because the exit would be in breach of the exiting-State’s treaty obligations – Article 140(3) TFEU provides for the *irrevocable* adoption of the euro – and the ECJ may be reticent to allow Article 65 to justify measures imposed in connection with such a fundamental treaty breach.

The Articles of Agreement of the IMF

The Articles apply to all IMF member states (which include all members of the eurozone, and indeed almost all countries in the world). The key provisions of the Articles which may impact the legality of any measures imposed by a state are:

- > **Article VI(3)** which provides that members may, at their discretion, impose controls on international *capital* flows (as distinct from *current* transactions);
- > **Article VIII(2)(a)** which prohibits the imposition of restrictions on the making of payments or on transfers for *current* international transactions, unless among other things:
 - the member has received IMF approval (as was the case with Iceland’s controls in 2008, albeit after their introduction); or
 - the IMF has declared the currency of that member to be scarce, (in effect this imposes particularly heavy constraints on restrictions on current transactions); and
- > **Article VIII(2)(b)** which provides for the unenforceability of certain “exchange contracts”. This provision, and its impact on the enforceability of contracts, is discussed further below.

Bilateral investment treaties

Bilateral investment treaties (BITs) establish the terms and conditions for private investment by nationals and companies of one state in another state, and often contain clauses providing for the free movement of capital so as to enable the repatriation of assets to investors. Whilst the relevance of BITs in an intra-EU context is minimal, and therefore not considered in detail here, it should be remembered that many EU Member States are party to BITs with non-EU Member States which could indirectly constrain the nature of capital controls which those states may be able to impose upon the occurrence of a financial crisis, or in the aftermath of a eurozone exit.

“Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments...”

Article VI(3)

“Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions”

Article VIII(2)(a)

Significance of legality of capital controls

The legality, under international treaties, of capital controls is significant for a number of reasons. Obviously, the imposing-State itself may be sanctioned in the international courts (such as the ECJ or the International Court of Justice). More significantly for businesses and financiers, the technical legality of the controls may also impact upon the enforceability of private contracts, as discussed in the next section of this Bulletin.

Enforceability issues

Potential conflicts

Where a contract is impacted by the introduction of capital control measures, there will often be a potential tension between the contractual obligation on a party to perform and a criminal or civil prohibition on that performance. For example, a bank may be instructed by its client to transfer cash or assets where that client (or its cash or assets) is subject to capital controls restricting such a transfer. In these circumstances, the bank may find itself in an invidious position whereby, in seeking to comply with the capital controls in order to avoid potential civil or criminal liability, it declines to act on the instructions and, as a result, it is itself then subject to a claim for damages by its client (the success of which would turn on the exact terms of business with the client) in a jurisdiction which does not uphold the capital controls. Conversely, if the bank were to comply with the client's instructions, it may find itself the subject of civil or criminal liability under the laws of the imposing-State. If the bank were to have staff or assets located in the imposing-State, or were to be operating under a local banking licence in that state, those staff and assets, and the likelihood of the banking licence continuing, could well be at risk.

It is therefore essential to be able to determine whether any particular contractual obligations will remain contractually enforceable despite the capital control measures.

Tests for enforceability of contracts

If a party seeks to enforce a contract in the courts of the imposing-State itself, it is unlikely that it will be successful in doing so. The courts of the imposing-State will normally be bound to apply the capital control legislation, even though the contract may itself be governed by the law of another jurisdiction and would otherwise be enforceable under that governing law.

More complex questions will arise in circumstances where the courts of a jurisdiction *other than* the imposing-State are asked to recognise the capital controls of the imposing-State, and as a result excuse performance of the contract. The conflict of laws rules which the courts of that jurisdiction apply, together with the substantive law of the contract in dispute, will then be crucial in determining the extent to which the non-defaulting party will be able to seek redress for non-performance.

English law (and, indeed, in broad terms the laws of many other major jurisdictions) will give effect to capital controls by determining a contract to be unenforceable by reason of those controls in three main scenarios:

- > where the governing law of the contract is that of the imposing-State;
- > where the place for performance of the contract is stipulated to be the imposing-State; and
- > where a contract is determined to be an “exchange contract” which falls within Article VIII(2)(b) of the IMF Articles and is inconsistent with the capital control legislation.

These are considered below in turn.

Governing law is that of the imposing-State

Where a contract is governed by the law of the imposing-State (see the box to the right for how this can be determined), an English court asked to enforce that contract against a non-performing party would generally be bound – by the provisions of the Rome I Regulation (the “Regulation”) or the Rome Convention (the “Convention”) – to apply the capital control legislation of the imposing-State and refuse to enforce the contract. The same result would arise in other EU Member States when applying those instruments. Likewise, this will be the result in many other key jurisdictions, such as New York and Hong Kong, which will generally give effect to the governing law of the contract.

Courts may, however, have some discretion (as provided for under Article 21 of the Regulation and Article 16 of the Convention) not to give effect to the capital controls where these are considered to be incompatible with the public policy of the court.² For example, an English court may decline to uphold the capital control legislation where it considers this to be oppressive or discriminatory. Indeed, it is possible that a court may decline to apply the legislation where the measures are held to be unlawful under the imposing-State’s treaty obligations (this may for example be where a court sitting in an EU Member State determines that the measures fall within the Article 63 TFEU prohibition discussed above). Similar discretions exist in New York and Hong Kong – although it remains unclear to what extent the courts of these jurisdictions might rely on such discretions in the context of, and in light of the legal issues surrounding, the use of capital controls as an economic management tool, particularly in the case of a eurozone exit.

Place of performance

Consistent with Article 9(3) of the Rome I Regulation, a court that is asked to enforce the performance of a contract may decline to do so where the obligations under the contract are to be performed in the imposing-State and where the capital controls of the imposing-State make performance there

² This is a discretion which would exist whenever the court was asked to give effect to such provisions – whether as a matter of the governing law of the contract, or by reason of a conflict of laws rule of the court, as discussed further below.

Which law governs the relevant contract?

Courts of EU Member States will generally determine this issue in accordance with the rules set out in the Rome I Regulation (for contracts entered into on or after 17 December 2009) or under the Rome Convention (for contracts entered into before that date and after the Rome Convention came into force in the Member State whose courts are seized).

The exception is Denmark which opted out of the Rome I Regulation, so the rules of the Rome Convention are applied by its courts to all relevant contracts.

Under these instruments, effect is broadly given to the parties’ express choice of law.

What if there is no express choice of law?

Whilst many contracts may specify such a choice, this is not always the case with certain financial transactions, especially those in the “cash” markets.

In such circumstances, if a choice cannot otherwise be inferred from the actions of the parties, these two instruments (which are largely identical on this point, so far as is relevant to this Bulletin) set out the means for determining the applicable law of the contract.

This is normally the habitual residence of the party required to perform under the contract (which, for sales contracts, is the person selling the asset, rather than the person purchasing the asset).

This can, however, be overridden by other factors which suggest that a contract is manifestly more closely connected with a certain country (which then result in the laws of that country governing the contract instead) – for example, in some cases, the country in which the obligations under the contract are to be performed.

unlawful. A court may choose to give effect to the capital controls of the imposing-State in this way, even if:

- > the contract is governed by a law other than that of the imposing-State (and such performance may indeed be otherwise lawful under that governing law); and
- > the party required to perform under the contract is neither a national of, nor resident in, the imposing-State.

Although this is the general approach taken by the EU courts under the Regulation, the position is less straightforward under the Convention (i.e. for those relevant contracts entered into prior to 17 December 2009). Article 7(1) of the Convention permits the application of the mandatory rules of a third state where there is a “close connection” with that state (which would cover illegality in the place of performance, but may indeed extend further than this). A number of EU Member States have, however, opted out of this provision³. Accordingly, in a case before the courts of such opting-out jurisdictions, the existence of capital controls in the place of performance might not, of itself, discharge an obligation.

Courts of some non-EU Member States will apply their own conflict of laws rules to such issues. For example, Hong Kong has a similar approach to that taken under the Regulation and courts sitting there may discharge an obligation on the basis of supervening illegality in the place of performance, regardless of what the governing law of the contract provides.

Where, under its governing law, the contract can be found to provide for alternative means of performing the contract, including for performance other than in the imposing-State, this can provide a court with a basis upon which to enforce the contract by these alternative means. For example, an English court may require performance in an alternative country specified for in the contract, where such performance is not unlawful under the laws of that country. The extent to which a court may be willing to order such performance, or find a contract to be enforceable on this basis (and thereby award damages for non-performance, for example), may depend upon:

- > the relative dates of the introduction of the capital controls and when the parties entered into the contract; and
- > the extent to which it can be demonstrated that the parties truly intended for the alternative country to be a place where the contract could be performed.

Exchange contracts

Article VIII(2)(b) of the IMF Articles provides for the unenforceability of certain “exchange contracts”.

The effect of this provision is that a contracting party cannot ask a court of an IMF-member state to force its counterparty to perform under a contract, or to order damages for breach of contract, where that contract falls within Article

“Exchange contracts which involve the currency of any member and which are contrary to the exchange control regulations of that member maintained or imposed consistently with this Agreement shall be unenforceable in the territories of any member...”

Article VIII(2)(b)

³ These are the UK, Germany, Ireland, Latvia, Luxembourg, Portugal and Slovenia.

VIII(2)(b). This Article therefore, in effect, provides the exchange control regulation with extra-territorial effect in other IMF-member states.

The impact of Article VIII(2)(b) upon the enforceability of a contract will turn on the construction which the relevant court gives to what constitutes an “exchange contract”:

- > Courts of certain jurisdictions – including England, the US and Belgium – have adopted a narrow construction of this term, interpreting this to mean only those contracts whose subject matter is the conversion of the currency of one state into the currency of another (for example, a currency swap or FX contract), or a contract which has the practical effect of so converting currencies.
- > Courts of other jurisdictions – including France and Luxembourg – have adopted a broader construction, holding that an “exchange contract” exists when its subject-matter can affect in any manner the currency of a country and therefore its balance of payments and/or exchange resources – effectively almost any contract in a foreign currency.

If the relevant court is one which adopts a narrow construction of this term, it is therefore less likely to determine a contract to be unenforceable than a court which adopts a broader construction.

Exchange control regulations must also be consistent with the regime set out in the IMF articles in order to fall within the scope of Article VIII(2)(b). The IMF will determine whether exchange control regulations which restrict international current transactions are so consistent – effectively approving the extra-territorial effect of such exchange control regulations. In the case of Iceland’s capital controls imposed in 2008 as part of an IMF Stand-By Arrangement, IMF approval was granted in respect of certain exchange restrictions on current international transactions, on the basis that they had been imposed for balance of payment reasons and were considered to be non-discriminatory. The IMF’s approval of these measures meant they were compliant with Article VIII(2)(a) (see above) and consequently given extra-territorial effect in IMF-member states pursuant to Article VIII(2)(b) by rendering certain exchange contracts unenforceable.

This result can be contrasted with the exchange controls imposed by Ukraine in 2008 which restricted various international current transactions. These controls, for which Ukraine sought IMF-approval at the time of the first review of its Stand-By Arrangement, included a restriction on the early payment of loans denominated in foreign currencies. IMF approval was not granted in respect of the capital controls on the grounds that the measures were discriminatory and therefore not consistent with the IMF Articles. The effect of this was that Article VIII(2)(b) was not triggered and IMF-member states were not obliged to give extra-territorial effect to such controls by holding relevant “exchange contracts” to be unenforceable.

The IMF has stated, following the implementation of Cyprus’s capital controls and restrictions on current transactions earlier that same day, that the bailout

agreement reached with Cyprus had its “full support”. It is presumably possible that such support may be withdrawn should the controls be extended in duration, as is widely expected. Until the IMF make any statement to the contrary, however, it seems accepted that the statement of “full support” mentioned above includes approval of the capital controls currently in place.

Even where an exchange contract is generally within the IMF regime, it is possible that a court may not be bound to hold an exchange contract to be unenforceable by reason of Article VIII(2)(b) where the exchange control legislation of the imposing-State is contrary to the international public policy of the jurisdiction in which the court sits. This may, for example, be because of the discriminatory or abusive nature of the legislation. Alternatively, a court might, for example, decline to enforce the contract on public policy reasons because such measures, whilst IMF-compliant, breached another international treaty to which the state in which that court sits is a party. In the case of an EU Member State, this may be because the measures breached Article 63 TFEU and were not justified within the scope of Article 65 TFEU as discussed above.

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